87 No. 1963

In The

Supreme Court of the United States

October Term, 1987

ANIELA KOZIARA,
EUGENE H. KOZIARA AND LAURA A. KOZIARA,
Petitioners,

-vs-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

– AND APPENDIX –

ROBERT M. JUSTIN
Counsel of Record
1142 North Main Street
Rochester, Michigan 48063
(313) 652-9000

T. S. GIVENS
Of Counsel on Certiorari

Interstate Brief & Record Company, *a division of* North American Graphics, Inc.
1629 West Lafayette Boulevard, Detroit, MI 48216 (313) 962-6230

QUESTION PRESENTED

WHETHER ROYALTY PAYMENTS RECEIVED BY THE PETITIONERS UNDER AN ILLEGAL COMPULSORY UNITIZATION ORDER WERE TAXABLE AS CAPITAL GAIN, RATHER THAN ORDINARY INCOME, BECAUSE THEY WERE THE PROCEEDS OF AN INVOLUNTARY CONVERSION WITHIN THE MEANING OF § 1231(a) OF THE INTERNAL REVENUE CODE.

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES CITED

PAGE

STATUTES:

MISCELLANEOUS:

No. _____

In The

Supreme Court of the United States

October Term, 1987

ANIELA KOZIARA,
EUGENE H. KOZIARA AND LAURA A. KOZIARA,
Petitioners,

-vs-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

CITATIONS TO OPINIONS BELOW

The decision of the United States Court of Appeals for the Sixth Circuit was entered on March 3, 1988 in the form of an order affirming the Tax Court without opinion. It is included as Appendix A.

The opinion of the United States Tax Court was entered on May 21, 1986 and is reported at 86 T.C. 999 (1986). That opinion is included as Appendix B.

JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit was entered on March 3, 1988 affirming without opinion the decision of the United States Tax Court. The jurisdiction of this Court is invoked under 28 USC 1254(1).

STATEMENT OF THE CASE

A. Summary Case History

Petitioners seek issuance of a writ of certiorari for review of the decision rendered below by the United States Court of Appeals for the Sixth Circuit. That decision affirmed without opinion an earlier ruling of the United States Tax Court that petitioners owe income tax deficiencies totaling $99,327.33. Petitioners Eugene and Laura A. Koziara challenge the Tax Court's decision that they owe income tax deficiencies of $6,856.23 for 1976 and $38,113.56 for 1977. Similarly, Eugene's mother, petitioner Aniela Koziara, challenges the Tax Court's decision that she owes income tax deficiencies of $1,623.16 for 1975, $9,414.35 for 1976 and $43,319.93 for 1977.

Appendix B sets out the opinion of the Tax Court which was rendered by Judge Stephen J. Smith on May 21, 1986. It is reported at 86 T.C. 999 (1986). Decisions on the companion cases were entered on October 6th and 7th of 1986. On January 5, 1987, the Koziara's filed timely notices of appeal to the U.S. Court of Appeals for the Sixth Circuit pursuant to the provisions of 26 USC 7482(a). (App. D)

On February 3, 1987, the Sixth Circuit granted petitioner's motion for consolidation and the Tax Court cases were consolidated for purposes of briefing and argument on appeal. (App. C) The case was submitted for oral argument on February 19, 1988 before Chief Judge Markey of the Federal Circuit sitting by designation and Circuit Judges Nelson and Morris. A decision affirming the Tax Court was rendered from the bench at the conclusion of oral argument. A few weeks later, on March 3, 1988, an order was entered affirming the judgment of the Tax Court upon that court's opinion.

B. Underlying Facts

The facts of the case are well settled. Both of the lower court decisions are based on the same set of stipulated facts and exhibits. The Stipulation of Facts is appended to this Petition as Appendix E.

During the 1975-77 period under scrutiny, petitioners Eugene H. Koziara and his mother, Aniela Koziara, owned 80 acres in the primary production area of a large reservoir of gas and oil in St. Clair County, Michigan. The formal name of that reservoir was the "Columbus Section 3 Saline – Niagran Formation Pool." In the remainder of this Petition — as well as in most of the record below — the reservoir is referred to simply as the "Columbus 3 Pool."

The land determined to be lying above the Pool was divided into eighteen distinct tracts. Three of these were jointly owned by the petitioners. Two 20-acre parcels were known as Tracts 1 and 2. A third, 40-acre parcel was known as Tract 6.

During the period relevant to this action, there were three operating wells located on the Petitioner's property. One well was on Tract 2 and two more were on Tract 6.

These wells were among the best-producing ones in the field. Depending on whose figures are used, they accounted for approximately 16¾% to 17⅓% or more of the oil and gas recovered from the reservoir. The economic benefit of this production was further divided between the "royalty interest" in the recovery attributed to each tract and the "working interest" in that tract.

Under Michigan law, "royalty interest" is statutorily defined as "that share of the produce or profits which the owner of land, or the oil and gas rights in such land, reserves or is entitled to whether under a lease or

under the provisions of this act in consideration of the owner of the working interest to develop such oil and gas mineral rights."[1] Traditionally, the standard share attributed to this interest is 1/8, or 12.5%. Similarly, "working interest" is statutorily defined in Michigan as "that share of the produce or profits to which the person who develops the oil and gas mineral rights is entitled by reason thereof pursuant to either the provisions of a lease providing therefor or to the provisions of this act."[2] The owner of this interest has the exclusive right to extract the gas and oil on the land. The working interest traditionally reserved is 7/8, or 87.5%. In addition, this interest is usually subject to reduction by responsibility for all the costs of exploration and development, while the royalty interest receives the proceeds of that interest free of those costs.

During the period in question, the Petitioners had a larger-than-usual owner's interest in their tracts. On Tract 2, they had a 20.83% royalty interest and a person named Adolph Rovsek owned the working interest in the sole well. (App. E, SF 18, E-4) On Tract 6, Sun Oil Company held the working interest in the two wells and the petitioners retained an 18.75% royalty interest. (App. E, SF 16, E-3–E-4) On Tract 1, they held a 100% interest. (App. E, SF 17, E-4) Although there were no wells on this parcel, slightly less than 1/2% of the total field production was attributable to it. (App. J)

Payments to the petitioners during the three years under consideration totalled $701,847.54. In addition, a

---

[1] MCL 319.102(E); MSA 13.140(2)(E). See also: *Mark* v. *Bradford*, 315 Mich. 50, 56-57, 23 N.W. 2d 201 (1946); *People* v. *Blankenship*, 305 Mich. 79, 86, 8 N.W. 2d 919 (1943).

[2] MCL 319.102(F); MSA 13.140(2)(3). See also: *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 261 n. 1, 78 S.Ct. 691, 2 L.Ed. 2d 743, reh. den. 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed. 2d 1071 (1958), as cited by the government below.

series of collateral state court decisions ultimately concluded that petitioners were entitled to an additional $187,815.85 from Sun Oil Company for oil and gas illegally removed from the field during the same period. (App. I)

Government involvement in the development of the field began with a Michigan Supervisor of Wells Compulsory Pooling and Uniform Well Spacing order issued May 22, 1969. Pooling is the bringing together of separately-owned small tracts for the purpose of regulating production from an underlying field and for granting well permits according to a rational pattern.[3] The process is "compulsory" when it can be required by statute, order, or regulation under state law. Michigan is one of more than 35 states which provides for such regulation.[4] Well spacing, as the name suggests, is the regulation of the number and location of wells over an oil or gas reservoir.

The rationale underlying this regulatory scheme has been succinctly summarized by Williams & Meyers:

> . . . It is generally agreed today that increased recovery from a reservoir is not a function of the number of wells drilled. Thus to the extent that more wells are drilled than are necessary for maximum recovery, there is economic waste, since the cost of drilling the unnecessary wells need not have occurred . . .
>
> In addition to curbing such waste, well spacing also prevents injury to the reservoir. Excessive rates of withdrawal from a reservoir,

---

[3] Williams & Meyers, *Oil & Gas Terms*, pp 99-100, 438 (4th Ed., 1976).

[4] See MCL 319.1 to 319.24; MSA 13.139(1) to 13.139(24) and Williams & Meyers, *Oil & Gas Terms*, § 905.1.

> particularly where the rate in one section is disproportionate to that in another, can result in physical waste from irregular or premature water or gas encroachment. Well spacing, based on a uniform pattern (such as one well to 40 acres), will inhibit such physical waste by making unnecessary disproportionate withdrawals . . .
>
> Williams & Meyers, *Oil & Gas Terms*, 649-650 (4th Ed., 1976) (citations omitted).

The constitutionality of compulsory pooling schemes as an exercise of state police power has been uniformly upheld. There is little doubt, however, that such schemes necessarily intrude to some degree on private property rights in order to promote the public good. In Michigan, this is a matter of explicit legislative policy. MCL 319.1; MSA 13.139(1) states in part:

> . . . It is accordingly the declared policy of the state to protect the interest of its citizens and landowners from unwarranted waste of gas and oil and foster the development of the industry along the most favorable conditions and with a view to the ultimate recovery of the maximum production of these natural products. To that end . . . [the Supervisor of Wells] . . . act is to be construed liberally in order that effect may be given to sound policies of conservation and the prevention of waste and exploitation.

If the Supervisor of Wells had, in fact, prevented exploitation in the instant cause — and had intruded no further than compulsory pooling and well spacing — petitioners would have little to complain about today. The government's interference with their property rights, however, was just getting underway.

Section 13 of the Supervisor of Wells Act (MCL 319.13; MSA 13.139(13)) authorizes that officer to enter proration orders which, *inter alia*, limit production so as "to prevent waste and to afford the owner of each property in the pool an opportunity to produce his just and equitable share of the oil and gas in the pool." By a production order which became effective on February 1, 1970, the state limited production in the Columbus 3 Pool to a maximum of 75 barrels per day for each well. In subsequent collateral state proceedings, the St. Clair County Circuit Court found that Sun Oil had intentionally and illegally violated this order to the tune of some 150,000 barrels. In retrospect, this finding casts a significant light on that company's action regarding the field.

On March 20, 1973, Sun Oil Company petitioned the State of Michigan to impose a compulsory unitization plan on the field. Although the term "unitization" is often used interchangeably with "pooling," it is more properly used to denominate the joint operation of all or some portion of the wells in a field as a single entity without regard to surface boundary lines and lease rights. Pooling, as noted earlier, is the term which describes the bringing together of small tracts sufficient for the granting of properly-spaced well permits.[5] When a field is unitized, the owners of the surface property within the drilling area surrender their existing royalty rights and are awarded an interest in the whole of what is legally produced. (App. E, SF 24, E-5)

It is this rearrangement of property rights that lies at the base of the instant controversy. As Williams and Meyers note:

---

[5] Williams & Meyers, *ibid*, p. 625.

> . . . To achieve the maximum objectives of a unitization program it is necessary that all persons having an interest in the program area become subject to the agreement. Without statutory compulsion, however, unanimity is frequently impossible to obtain. The principal obstacle to full, voluntary agreement is the problem of dividing the proceeds of production. Even under a compulsory unitization statute, the problem of dividing the proceeds of production creates considerable difficulty inasmuch as every compulsory unitization statute requires prior agreement of a substantial majority of the persons interested in the area to be unitized to a unitization plan, and agreement must be reached by such persons on such matters as division of the proceeds of development before the regulatory commission may act upon the plan.
>
> Williams & Meyers, *ibid* at pp. 100-101.

Michigan provides a comprehensive statutory scheme for compulsory unitization in the form of the "Michigan Unitization Law," MCL 319.351 *et seq*; MSA 13.139(101) *et seq*. The statute grants broad powers to take and modify preexisting contractual and property rights. Section 14, for example, provides:

> . . . Operations conducted pursuant to an order of the supervisor for unit operations shall constitute a fulfillment of all the express and implied obligations of each lease or contract covering lands in the unit area to the extent that compliance with the obligations cannot be had because of the order of the supervisor.
>
> MCL 319.364; MSA 13.139(114).

Similarly, § 18 of the law provides for the unilateral taking of private rights inconsistent with a unitization order. It explicitly states:

> Property rights, leases, contracts and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of the act and to any valid and applied plan of unitization or order of the supervisor made pursuant to this act.
>
> MCL 319.368; MSA 13.139(118).

The next section of the law goes even further. It allows for a taking in the form of intrusion into the royalty and overriding royalty interest normally insulated from the costs of production. Section 19 initially provides, in relevant part:

> . . . Subject to reasonable limitations as set out in the plan of unitization, the unit shall have a first and prior lien for costs incurred pursuant to the plan of unitization upon the leasehold estate and other oil and gas rights, exclusive of a 1/8 share of gross production which is attributable to a lessor's royalty interest, in and to each separately owned tract, and the interest of the owners thereof in and to the unit production and equipment in possession of the unit.
>
> MCL 319.369; MSA 13.139(119).

The statute then goes on to articulate an important and far-reaching modification of these generally recognized principles of allocation:

> . . . The interest of the person who by lease, contract, or otherwise would be responsible for the cost of developing and operating a given portion

> of the unit area in the absence of unitization shall be primarily responsible for costs as allocated by the plan of unitization, and resort may be had to the entire 7/8 of gross production, *including but not by limitation overriding royalties, oil and gas payments and royalty interest in excess of 1/8 of gross production but which would not otherwise be responsible for allocated costs*, only if the person primarily responsible fails to pay the allocated costs in accordance with the unit plan . . .
>
> *Id.* (emphasis supplied).

The section then finishes by providing for subrogation of rights "foreclosed" by its terms:

> . . . Persons whose allowable share of production is made secondarily responsible under the provisions of this section to the extent that their interest is foreclosed shall become subrogated to all the rights of the unit to the interest or interests primarily responsible.
>
> *Id.*

The State of Michigan, through its statutory agent, the Supervisor of Wells, reviews each request for unitization in light of both the general public use and purpose standards, and the specific practical considerations, set out in the statutes.[6] On June 20, 1973, the Supervisor issued a provisional order granting the unitization request of Sun Oil Company. A permanent order was made contingent upon the submission of evidence of written approval of the unitization plan by at least

---

[6] See MCL 319.1; MSA 13.139(1) and MCL 319.355; MSA 13.139(105).

75 percent of the interest owners of record as required by § 7 of the unitization law.[7]

Sun Oil Company submitted evidence which allegedly indicated that 76.65132% of the interest owners had agreed to their proposed plan. (App. F) Based on this submission, the Supervisor issued a final compulsory unitization order on June 25, 1974. (App. E, SF 29, E-7) For purposes of this proceeding, however, the parties have stipulated that this submission was false. Due to overproduction of oil in the fourth quarter of 1971 by Sun Oil Company, the tract participation of the petitioners and the Wronskis was underestimated. This, in turn, created a situation in which their nonconsent fell just short of the 25% needed to block unitization pursuant to § 7 of the Michigan Unitization Law. (App. E, SF 53-57, E-12–E-14)

If their interests had been properly calculated, Sun Oil would not have been able to obtain the requisite consent of 75% of the royalty interest owners. Thus the unitization itself was illegal and without statutory basis. The government's position, however, is that whether or not the unitization was "legal" or "illegal" pursuant to state law has no bearing on the character

---

[7] MCL 319.357; MSA 13.139(107) provides:

> No order of the supervisor providing for unit operations shall be declared or become effective until the plan for unit operations prescribed by the supervisor has been approved in writing by those persons who under the supervisor's order will be required to pay at least 75% of the costs of unit operation; and also those persons who are owners of record of at least 75% of the production or proceeds thereof that will be credited to interest which are free of costs such as but not limited to royalties, and production payments; and until the supervisor has made a finding, either in the order providing for unit operations or in a supplemental order as hereinafter provided, that the plan for unit operations has been so approved in writing.

and nature of the sums the petitioners received under the terms of the order. (App. E, SF 54, E-13)

As a result of the order, in any case, some of the petitioners' existing property rights were modified so that they were credited with only a 17.33183% ownership interest free of cost in the unitized tract. (App. E, SF 13, 14, 58, E-3, E-14 – E-15; App's. F, G, H, J) In addition, the petitioners no longer enjoyed exclusive override royalty rights to the wells on their property. (*Id.*)

On June 29, 1974, petitioners filed an administrative appeal with the Supervisor of Wells Appeal Board attacking the Final Compulsory Unitization Order of June 25, 1974. On July 5, 1974, adjacent landowners Wronski also filed an appeal and the cases were subsequently consolidated for purposes of the administrative appeal.

The petitioners alleged that the royalty participation percentages set out in the order were arbitrary and unreasonable in that one of the largest parts of the oil field lay under their property and that the share assigned to them would not return to them what the property was worth. (App. E, SF 56, E-14; App's. F, G, H, J) Secondly, they argued that the order violated Federal and State Anti-Trust and Restraint of Trade statutes. Finally, they argued that both the unitization order and the underlying unitization statute suffered from grave constitutional defects.[8]

---

[8] See: *Wronski* v. *Sun Oil Co.*, 108 Mich. App. 178, 182, 310 N.W. 2d 321, 322 (1981) where the Michigan Court of Appeals noted that "(t)he particulars of the constitutional attack included allegations that: (1) the unitization order impaired the obligations of contracts, (2) the order constituted an unlawful taking of property rights without due process, (3) the order in effect constituted an unlawful condemnation of property since no showing of public necessity was made, (4) the unitization plan was discriminatory and constituted a denial of equal protection, and (5) MCL Section 319. 357; MSA 13.139(107) itself is unconstitutional as depriving plaintiffs of valuable property rights without a trial by jury."

On January 17, 1975, the administrative hearing examiner for the Supervisor of Wells Appeal Board granted the petitioners' request to hold the appeal in abeyance until discovery was completed — apparently in regard to newly discovered evidence of overproduction by Sun Oil. In the period from January 1975 to December 1978, the petitioners filed a series of petitions for rehearing, transfer, amendment of appeal, disqualification and immediate hearing before the Appeal Board.[9] Finally, in January of 1979 the hearing officer granted Sun Oil's Motion to Dismiss Due to Delay. The Ingham County Circuit Court denied a petition to review this decision without issuing a written opinion. Finally, the Michigan Court of Appeals partially affirmed the dismissal of the petitioners' administrative appeal but remanded the case to the Circuit Court for further review and to provide the petitioners an opportunity to prove at some level that their royalty interest under the unitization order and agreement should be increased due to Sun Oil's illegal overproduction of oil between February 1, 1970 and June 30, 1974. *Id.* at 191, 310 N.W. 2d at 326.

In the meantime, while the administrative appeals were being bandied about, the petitioners and the Wronskis had filed a separate lawsuit before Michigan's St. Clair County Circuit Court. Their complaint, filed in April of 1975, alleged that Sun Oil had systematically and illegally overproduced oil from three other wells in the field and that a substantial portion of the overproduction had been drained from beneath their lands.

After a three week bench trial, the St. Clair County Circuit Court found that Sun Oil systematically overproduced the field by some 150,000 barrels and that one-third of this oil had been drained from the Plain-

---

[9] For a fuller description of this procedural maneuvering see *Wronski, supra*, 310 N.W. 2d at 323.

tiffs' property. The Court then went on to hold that the oil company's actions constituted tortious breaches of their lease obligations to the Plaintiffs as to the oil beneath their property. Next, the Court awarded compensatory damages to the petitioners as follows:

> . . . The Court finds that the 50,000 barrels of oil illegally drained from beneath the Wronski and Koziara tracts are to be valued at the rate of $12.50 per barrel and are to be allocated in accordance with their relative allocation factors based on the participation percentages set forth in Plaintiffs' exhibit No. 7 and reduced by the percentage royalty ownership of the respective Plaintiffs in each tract. The Court finds Koziara Tract No. 1 to have an allocation factor of .405% and a royalty ownership of 100%, Koziara Tract No. 2 to have an allocation factor of 13.21% and a royalty ownership of 20.83%, Koziara Tract No. 6 to have an allocation factor of 59.218% and royalty ownership factor of 18.75%. The Court finds compensatory damages to be awarded the Plaintiffs Koziara against Defendant Sun Oil Company in the amount of Eighty-Nine Thousand One Hundred Twenty-Seven and 00/100 ($89,127.00) Dollars . . .
>
> Trial Court Opinion, pp. 15-16. (App. I, I-16)

Finally, the Court also awarded exemplary damages, saying:

> . . . In considering the amount of exemplary damages to be assessed against Defendant Sun Oil Company in this case, the Court takes judicial notice that the legislature of the State of Michigan has enacted a number of different treble damage statutes. These treble damage statutes are by their nature exemplary and punitive in effect . . . In the case at bar, the actions of

> Defendant Sun Oil Company in intentionally, willfully and illegally overproducing adjacent wells and draining oil from beneath Plaintiffs' properties is in the nature of a trespass. Defendant Sun Oil Company had no legal or contractual right to drain Plaintiffs' properties. The drainage was a willful, tortious breach of Plaintiffs' contract rights and violation of Sun Oil Company's common law obligations to Plaintiffs' property rights . . .
>
> (*Id.*)

The Court determined on the basis of all the testimony and evidence in this case, and after considering the matters stated above, that it would be reasonable and proper to assess exemplary damages against Defendant Sun Oil Company in the amount of Fifty (50%) percent of the compensatory damages previously awarded to the Plaintiffs:

> The Court finds exemplary damages to be assessed against Defendant Sun Oil Company in the amount of Forty-four Thousand Five Hundred Sixty-Three and 50/100 ($44,563.50) Dollars and awarded to Plaintiffs Eugene H. Koziara and Aniela Koziara . . .
>
> Trial Court Opinion, pp. 17-19. (App. I, I-17 – I-19)

On appeal, the Michigan Court of Appeals affirmed the findings of the Circuit Court, but reduced the amount of the damages. *Wronski* v. *Sun Oil Co.*, 89 Mich. App. 11, 279 N.W. 2d 564 (1979).

C. The Tax Returns and Tax Proceedings Below

During the taxable years 1975, 1976, and 1977, petitioners received total royalty income from Sun Oil Company as follows:

Year	*Total Royalty*	*Royalty Income Attributed to Each Taxpayer*
1975	$212,764.14	$106,382.07
1976	$275,735.60	$137,867.80
1977	$213,347.80	$106,673.90

As indicated in this table, 50% of the total royalty income reported paid by Sun Oil is attributable to petitioner Aniela Koziara and 50% to petitioner Eugene Koziara and his wife. On their respective 1975 and 1976 returns, the petitioners included their 50% royalty shares as ordinary income.

On their 1977 returns, however, they reported the payments received as the proceeds of an involuntary conversion because a portion of their mineral interests had been taken from them pursuant to an improper and illegal unitization under Michigan law. In addition, petitioners subsequently filed amended returns for 1975 and 1976. On these amended returns, they asserted that the payments received in those years were also proceeds of the continuing involuntary conversion and had thus been erroneously included as income – resulting in an overpayment of taxes.

On audit, the Commissioner determined that no involuntary conversion within the meaning of 26 USC 1231 had occurred. Therefore, the payments received from Sun Oil in the years at issue were held to be taxable as ordinary income and deficiencies were accordingly assessed. In addition, certain deductions claimed by the petitioners in those years were disallowed.

The petitioners timely sought to contest the asserted deficiencies before the Tax Court. The parties stipulated as to the Commissioner's disallowance of certain deductions. Thus the sole issue presented to the Tax Court for decision was whether the payments received

by the petitioners pursuant to the compulsory unitization were taxable as ordinary income or capital gain.

The petitioners argued that the payment they received under the unitization agreement imposed upon them were taxable as capital gain only, and not as ordinary income. This argument, in turn, was based on the assertion that the legal effect of the compulsory unitization of their interest in the Columbus 3 Pool was an involuntary conversion of their property as a result of "an exercise of the power of requisition or condemnation" as envisioned by § 1231 of the Code. The Commissioner responded that no "requisition or condemnation" had occurred and that the payments were therefore taxable as ordinary royalty income. The matter was submitted to the Court on cross motions for summary judgment and it rendered an opinion holding for the Commissioner. (App. B) The Sixth Circuit affirmed without opinion.

Petitioners now seek issuance of a writ of certiorari to review the decisions rendered below.

REASONS FOR GRANTING THE WRIT

ROYALTY PAYMENTS RECEIVED BY THE PETITIONERS UNDER AN ILLEGAL COMPULSORY UNITIZATION ORDER WERE TAXABLE AS CAPITAL GAIN, RATHER THAN ORDINARY INCOME, BECAUSE THEY WERE THE PROCEEDS OF AN INVOLUNTARY CONVERSION WITHIN THE MEANING OF § 1231(a) OF THE INTERNAL REVENUE CODE.

The Commissioner relies on the proposition that "royalty payments are taxable as ordinary income" much as an inebriate relies on a lampost — more for a false sense of support than for illumination. See: *Burnett Harmel*, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199 (1932);

Bankers Pocahontas Coal Co. v. *Burnet*, 287 U.S. 308, 53 S.Ct. 150, 77 L.Ed. 325 (1932); *Green* v. *Commissioner*, 35 T.C. 1065, 1070 (1961). The parties to this controversy all recognize that § 1231(a) of the Internal Revenue Code provides a clear exception to the proposition. The real issue is whether or not that exception is applicable to the specific facts and circumstances of this case.

Section 1231(a) provides, *inter alia*, that recognized gains from the compulsory or involuntary conversion of property used in a trade or business and capital assets shall be treated as capital gains income. That section, as applicable to the years in question here, provides in pertinent part:

> (a) General Rule.
> — If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the *compulsory or involuntary conversion* (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power or requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months (9 months in 1977) into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months (9 months in 1977). If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets . . . .
>
> (Emphasis added.)

Section 1.1231-1(e), Income Tax Reg's., in turn, defines "compulsory or involuntary conversion" as follows:

> (e) *Involuntary conversion* — (1) *General Rule.* For purposes of section 1231, the terms "a compulsory or involuntary conversion" of property means the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, *or an exercise of the power of requisition or condemnation,* or the threat or imminence thereof . . . .
>
> (Emphasis added.)

The petitioners argue that the illegal and compulsory unitization which took place was clearly the result of such a "requisition or condemnation."

The Commissioner, however, points to *American Natural Gas Co.* v. *United States,* 279 F2d 200 (Ct. Cl., 1960), cert. den. 364 U.S. 900 (1960), which holds that "requisition or condemnation" means no more than the exercise of the power of eminent domain. Since there was no formal eminent domain action or direct taking by the state, the government reasons, there was no requisition or condemnation. Since there was no condemnation, there was no taking and therefore no involuntary conversion. Without the requisite involuntary conversion, there can be no capital gains treatment of the proceeds.

What this analysis overlooks, however, is that there can be an exercise of eminent domain by what has come to be known as "inverse condemnation." In *Jacobs* v. *United States,* 290 U.S. 13, 16, 54 S.Ct. 26, 78 L.Ed. 142 (1933), this Court, speaking through Chief Justice Hughes, noted:

> . . . The (inverse condemnation) suits were based on the right to recover just compensation for property taken by the United States for public use in the exercise of its power of eminent domain. That right was guaranteed by the Constitution. The fact that condemnation proceedings were not instituted and that the right was asserted in suits by the owners did not change the essential nature of the claim. The form of the remedy did not qualify the right. It rested upon the Fifth Amendment. Statutory recognition was not necessary. A promise to pay was not necessary. Such a promise was implied because of the duty to pay imposed by the Amendment. The suits were thus founded upon the Constitution of the United States. USC Title 28, Section 41(20).

Since this decision, the Court has repeatedly reaffirmed the Fifth Amendment foundation of these suits and a rapidly expanding body of law is beginning to develop. See: *First English Evangelical Lutheran Church of Glendale* v. *County of Los Angeles*, __ US __, 107 S.Ct. 2378, 96 L.Ed. 2d 250 (1987); *Kirby Forest Industries, Inc.* v. *United States*, 467 U.S. 1, 104 S.Ct. 2187, 81 L.Ed. 2d 1 (1984); Ticer, "Civil Rights for the Propertied Class: The Development of Inverse Condemnation in the Federal Courts," 55 Tulane L. Rev. 897 (1981).

Petitioners do not dispute the principle articulated by the Commissioner below that eminent domain — including inverse condemnation — must be distinguished from the exercise of the police power of the state. It is well established that eminent domain involves the taking of property for public purposes while the police power involves the regulation of property. 1 Nichols, The Law of Eminent Domain, § 1.42 at pp. 1-127 (Rev.

3d Ed., 1985). This formulation, however, ultimately begs the question presented here.

The police power and the power of eminent domain are not separate conceptual entities in this context. Rather, they represent the polarities of a single continuum. Whether or not a "taking" has occurred in a given case depends on where the facts and circumstances of the case fall along the continuum.

This Court has long recognized this concept. In *Pennsylvania Coal Co.* v. *Mahon*, 260 U.S. 393, 415, 43 S.Ct. 1548, 67 L.Ed. 322 (1922), Justice Holmes noted:

> The general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking . . .

Even where the taking has a perfectly legitimate purpose, the rights of the general public must yield to the rights of the property owner if the regulation too greatly impinges upon private rights. In addition, Justice Holmes pointed out at 260 U.S. 413:

> We are in danger of forgetting that a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change. As we already have said, this is a question of degree — and therefore cannot be disposed of by general propositions.
>
> . . . As long recognized, some values are enjoyed under an implied limitation and must yield to the police power. But obviously the implied limitation must have its limits, or the contract and due process clauses are gone. One fact for consideration in determining such limits is the extent of the diminution. *When it reaches a*

> *certain magnitude*, in most if not in all cases there must be an exercise of eminent domain and compensation to sustain the act. So the question depends upon the particular facts. The greatest weight is given to the judgment of the legislature, but it always is open to interested parties to contend that the legislature has gone beyond its constitutional power.
>
> (Emphasis added.)

Beyond the enunciation of these general principles, the Court has not developed any hard and fast rules for determining where a specific set of facts lies on the continuum. Rather, there has been a continuing emphasis on the particular facts of each case being reviewed. See, for example, *United States* v. *Caltex (Philippines) Inc.*, 344 U.S. 149, 73 S.Ct. 200, 97 L.Ed. 157, reh. den. 344 U.S. 919, 73 S.Ct. 345, 97 L.Ed. 708 (1952) and *United States* v. *Central Eureka Mining Co.*, 357 U.S. 155, 78 S.Ct. 1097, reh. den. 358 U.S. 858, 3 L.Ed. 2d 91 (1958).

This is not to say, however, that the area is completely devoid of guidelines. In *Penn Central Transp. Co.* v. *New York City*, 438 U.S. 104, 123-124, 98 S.Ct. 2646, 57 L.Ed. 2d 631 (1978), this Court noted the difficulty of developing a "set formula" for application to the multiplicity of situations which present themselves:

> . . . The question of what constitutes a "taking" for purposes of the Fifth Amendment has proved to be a problem of considerable difficulty. While this Court has recognized that the "Fifth Amendments guarantee . . . [is] . . . designed to bar government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole," . . .

> the Court, quite simply has been unable to develop any "set formula" for determining when "justice and fairness" require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons . . . Indeed, we have frequently observed that whether a particular restriction will be rendered invalid by the government's failure to pay for any losses proximately caused by it depends largely "upon the circumstances [in that] case" . . .
>
> (Citations omitted.)

Nonetheless, it then went on to identify several significant factors to be considered:

> . . . In engaging in these essentially *ad hoc*, factual inquiries, the Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations . . . So, too, is the character of the governmental actions. A "taking may more readily be found when the interference with property can be characterized as a physical invasion by government . . . than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good . . .
>
> *Id.* at 124 (citations omitted).

Accord: *Ruckelshaus* v. *Monsanto Co.*, 467 U.S. 986, 104 S.Ct. 2862, 81 L.Ed. 2d 815 (1984). These general considerations, in turn, serve as a conceptual super-

structure for a series of narrower factors that may also be considered.

Often these narrower considerations are cast in negative terms, i.e. they articulate what is *not* required in order for a taking to have occurred. It is clear, for example, that a "taking" does not require that the government actually take title. *United States* v. *Kansas City Life Insurance Co.*, 339 U.S. 799, 70 S.Ct. 885, 94 L.Ed. 1277 (1950); *United States* v. *Causby*, 328 U.S. 256, 66 S.Ct. 1062, 90 L.Ed. 1206 (1946). It is sufficient if the governmental action involves a direct interfence with, or disturbance of, a sustantial property right. *Pumplelly* v. *Green Bay Co.*, 80 U.S. (13 Wall) 166, 20 L.Ed. 557 (1871); *United States* v. *Lynak*, 188 U.S. 445, 23 S.Ct. 349, 47 L.Ed. 539 (1903); *United States* v. *Cress*, 243 U.S. 316, 37 S.Ct. 380, 61 L.Ed. 746 (1917). Similarly, neither direct physical invasion, possession nor governmental use are mandatory requirements. *NL Industries* v. *United States*, 12 Cl. Ct. 391, 396-397 (1987); *R.J. Widen Co.* v. *United States*, 357 F2d 988 (Ct. Cl., 1966).

The rationale underlying these concepts was succinctly summarized in a recent Pennsylvania case, where the Court noted:

> It was not necessary, contrary to DOT's contentions, for the trial court to make a determination of the exact physical nature and extent of the taking. The trial court correctly perceived that in a *de facto* taking, the old concept of property as a physical object has given way to the present concept of considering property as a bundle of rights or interests pertaining to the physical object . . .
>
> Nor was it necessary, contrary to DOT's contentions, that there be a physical moving onto

> the property of appellees. Substantively there is no essential difference between the taking of a person's property in the exercise of the police power by some regulation controlling the flight of airplanes or traffic patterns and a taking by a physical invasion of that person's property in an eminent domain proceeding. Thus, where the impact of the governmental agency's conduct was sufficiently substantial to infringe on the beneficial use and enjoyment of the property, it triggers the Fifth and Fourteenth Amendments.
>
> *Com. Dept. of Transp.* v. *Meyers*, 522 A2d 112, 114 (Pa., 1987).

See also: *United States* v. *General Motors Corp.*, 323 U.S. 373, 377-378, 65 S.Ct. 357, 89 L.Ed. 311 (1945).

Finally, it has also been held that the property owner does not even need to demonstrate that the state benefitted from the taking. Rather, the focus is on the harm done to the individual. See, for example, *Cereghino* v. *State Highway Commission*, 230 Or. 439, 450, 370 P2d 694 (1962).

Despite the ever-expanding impact of these principles, however, the I.R.S. and Tax Court have long clung to an extremely narrow view of the involuntary conversion provision of § 1231(a) and its predecessors. *Cf.* Rev. Rul. 58-11, 1958-2 Cum. Bull. 8, and Rev. Rul. 57-314, 1957-27 Cum. Bull. 6. This doctrinal inflexibility has, in turn, drawn the fire of the commentators:

> The first problem that would arise if an entering participant attempted to fit his leasehold interest into the involuntary conversion category is whether there had been any "seizure, or requisition or condemnation or threat or imminence thereof" in the course of the compulsory

> unitization. The Tax Court's contract theory of unitization seems almost by definition to foreclose any contention that anything was taken from the entering participant. But does the Tax Court's theory stand up in the light of the actual facts in a truly compulsory unitization? What if the entering participant's producing leasehold is converted to input wells, or to a non-producing portion of the unit, under the terms of the order which includes the leasehold within the unit? Under such circumstances it would seem that there has been a taking of some of the entering participant's rights to his minerals in place. Furthermore, if the basis of the order is a statutory directive to reduce waste and conserve the state's natural resources, then the taking of the entering participant's rights is closely akin to the taking of private property for public use . . .
>
> 9th Annual Institute on Oil and Gas Law, "Recent Oil and Gas Taxation Developments," p. 591, Southwestern Legal Foundation, Dallas, Texas (1958) (footnote deleted).

The instant case presents a stipulated set of facts closely analogous to those envisioned in this passage.

First of all, Michigan's entire compulsory pooling and unitization procedure is predicted on precisely the kind of legislative directive mentioned above. See: MCL 319.1; MSA 13.139(1). Furthermore, the Michigan legislature had determined that a proper balance of public and private interests required that 75% of the private owners in the proposed unit must consent in writing to the unitization before it could even take place. MCL 319.357; MSA 13.139(107). In this case, the requisite consent was not obtained. (App. E, SF 54, E-13) Thus, the unitization was not only illegal and violative of the

statutory protections set out, but it was "truly compulsory" in two senses. First, it was imposed without the consent of the petitioners. (App. F) Secondly, it was also imposed without even the consent of the required majority.

In addition, the illegal unitization order clearly operated as a taking of the petitioners' property rights. As noted earlier, the petitioner's property was the situs of some of the best-producing wells in the field. Also, they had larger-than-usual royalty interests in their tracts. Instead of the usual 12½% interests, under their leases they enjoyed interests ranging from 18¾% to 100%. Finally, they also enjoyed exclusive override royalty rights on parts of their property.

As a result of the order, the petitioners' existing property rights were modified so that they were credited with only a 17⅓% interest free of cost in the unitized tract. They also no longer enjoyed exclusive override royalty rights nor immunization from cost liability on their entire contractual royalty interests. As noted earlier, these substantive modifications were effectuated by a series of provisions in Michigan's Unitization Law. See: MCL 319.364; MSA 13.139(114) (operations pursuant to a unitization order constitute automatic fulfillment of existing contractual obligations), MCL 319.368; MSA 13.139(118) (unilateral modification of all inconsistent contract rights) and MCL 319.369; MSA 13. 139(119) (reallocation of costs by foreclosure of overriding and other "nonstandard" royalties).

The economic impact of these changes on the petitioners is clear. A portion of the property has been completely taken and redistributed to other private owners by virtue of their reallocation. A significant portion of their remaining interests have been exposed to cost allocations from which they were immune

under the lease provisions. Their exclusive right to override royalties has been rendered nonexclusive and subject to cost allocation. They could be — and were — subjected to what amounted to theft of their oil and gas in place by virtue of Sun Oil's power to manipulate the field as a whole. All of these factors were further aggravated by the fact that the unitization itself was based on a fraudulent submission which effectively subverted the few safeguards that the Michigan Legislature attempted to build into the Unitization Law. Under these circumstances, a "taking" clearly took place.

A number of decisions in analogous situations tend to support this conclusion. For example, see: *Hall* v. *City of Santa Barbara*, 833 F2d 1270, 1276 (CA 9 Amended Opinion, 1986) (operators of a mobile home park would be entitled to compensation for taking of their possessory interest in land under rent control ordinance, notwithstanding that they would continue to receive rental payments); *Western Energy Company* v. *Genie Land Company*, 737 P2d 478 (Mont., 1987) (statutory provision altering unexpired leasehold interest by requiring separate consent or waiver by surface owner prior to mineral estate owner's exercise of contractual rights violated state constitutional prohibitions against taking of private property without due process or just compensation and impairment of obligation of contract); *Frost* v. *Ponca City*, 541 P2d 1321 (Okl., 1975) (state may estabish regulations regulating or partially abrogating the law of capture, but may not authorize third persons to enter upon a landowner's premises and capture underlying minerals without compensation). See also: *Department of Natural Resources* v. *No. 8 Limited of Virginia*, 528 S.W. 2d 684 (Ky., 1975).

Finally, the government may not avoid these authorities by reliance on *Commissioner* v. *Gillette Motor*

Co., 364 U.S. 130, 80 S.Ct. 1497, 4 L.Ed. 2d 1617 (1960). In that case, the U.S. Government took over the operation of a common carrier during World War II. This "temporary taking" was described by this Court as follows:

> . . . (B)ecause of the need for respondent's facilities in the transportation of war material, the President ordered the Director of the Office of Defense Transportation to "take possession and assume control of" them. The Director assumed possession and control as of August 12 and appointed a Federal Manager, who ordered respondent to resume normal operations. The Federal Manager also announced his intention to leave title to the properties in respondent and to interfere as little as possible in the management of them. Subject to certain orders given by the Federal Manager from time to time, respondent resumed normal operations and continued so to function until the termination of all possession and control by the government on June 16, 1945 . . .
>
> *Id.* at 131.

Despite the minimal nature of this intrusion, the Court upheld the finding of the Motor Carrier Claims Commission that there had been a "taking" of Gillette Motor's property. The Court then went on to note, however, that what was taken was only "the right to determine freely what use to make of its transportation facilities." *Id.* at 133.

Next it was pointed out that this right to use was not a capital asset but "simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent." *Id.* at 135. Since there was no capital asset involved, the compensation awarded for the use was treated as ordinary income.

The instant case is readily distinguishable from *Gillette, supra.* The lessee's interest in gas and oil in place is clearly an interest in real property which is a capital asset. See: Rev. Rul. 68-226, 1968-1 Cum.Bull. 362. Part of the effect of the compulsory unitization was the transfer of a portion of this physical asset to others. Unlike the property in *Gillette,* the petitioners' property has not been returned by the government. Thus, the value to the landowners' property has been impaired in two ways. First, there was a transfer by redistribution under the unitization order. Second, there was a severe restriction on the scope of their right to capture the gas and oil free of cost allocation and thus enjoy the full economic benefit of their ownership.

CONCLUSION

For the reasons outlined above, this Court should conclude that the royalty payments received by the petitioners under an illegal compulsory unitization order were taxable as capital gain, rather than ordinary income, because they were the proceeds of an involuntary conversion within the meaning of § 1231(a) of the Internal Revenue Code and issue a writ of certiorari to the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

By: /s/ ROBERT M. JUSTIN
Counsel of Record
1142 North Main Street
Rochester, Michigan 48063
(313) 652-9000

T. S. GIVENS
Of Counsel on Certiorari

Dated: May 27, 1988

APPENDICES TO PETITION FOR CERTIORARI

• • •

APPENDIX A

ORDER

(United States Court of Appeals — Sixth Circuit)

(Filed March 3, 1988)

(ANIELA KOZIARA, EUGENE H. KOZIARA AND LAURA A. KOZIARA, Petitioners-Appellants vs. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee – NOS. 87-1054/1055)

BEFORE: NELSON and NORRIS, Circuit Judges;
MARKEY, Circuit Judge*

This cause having come on to be heard upon the record, the briefs and the oral argument of the parties, and upon due consideration thereof,

It is ORDERED that the judgment of the Tax Court be, and it hereby is, affirmed upon the opinion of the Tax Court.

ENTERED BY ORDER OF THE COURT
/s/ John P. Hehman,
Clerk

---

* The Honorable Howard T. Markey, Chief Judge, United States Court of Appeals for the Federal Circuit, sitting by designation.

APPENDIX B

OPINION

(United States Tax Court)

(Filed May 21, 1986)

(EUGENE H. KOZIARA and LAURA A. KOZIARA, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent; ANIELA KOZIARA, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent — 86 T.C. No. 61; Docket Nos. 10828-80, 11321-80.)

Petitioners owned land in Michigan under which oil and gas deposits were located. Oil and gas deposits also were located under land adjacent to petitioners' land. The deposits were part of a single, larger reservoir of oil and gas. In 1973, the Michigan Supervisor of Wells issued an order under Michigan law (referred to as a unitization order) restricting petitioners and the other owners of land overlaying the oil and gas reservoir from independently extracting oil and gas from the reservoir. Under the unitization order, only Sun Oil Company was allowed to extract oil and gas from the reservoir and the land owners were to receive a percentage of all royalty payments received with respect to oil and gas extracted.

Held, the unitization order did not constitute an involuntary conversion of petitioners' rights to a portion of the oil and gas deposits. Royalty payments received by petitioners with respect to oil and gas extracted from the reservoir are taxable as ordinary income.

Robert M. Justin, for the petitioners.
Clyde W. Mauldin, for the respondent.

OPINION

SWIFT, *Judge*.

This matter is before the Court on cross motions for summary judgment, filed October 19, 1984. These

cases have been consolidated for purposes of trial, briefing, and opinion. The pertinent facts have been fully stipulated and are set forth below.

In separate statutory notices of deficiency dated April 7, 1980, respondent determined deficiencies in petitioners' Federal income tax liabilities and additions to tax as follows:

Petitioners Eugene H. Koziara and Laura A. Koziara — Docket No. 10828-80

Year	*Deficiencies*	*Additions to Tax — Section 4973*[1]
1975	$ 244.29	$73.38
1976	7,144.93	73.38
1977	38,113.56	73.38

Petitioner Aniela Koziara — Docket No. 11321-80

Year	*Deficiencies*
1975	$ 1,623.16
1976	9,414.35
1977	43,319.93

Following concessions, the issue remaining for decision is whether royalty payments received by petitioners in 1975, 1976, and 1977 from Sun Oil Company with respect to their interests in certain oil and gas deposits constitute ordinary income, or whether the royalty payments constitute capital gain income because they allegedly arose out of a condemnation or involuntary conversion of petitioners' rights to a portion of the oil and gas deposits.

---

[1] All section references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

Petitioners, Eugene H. and Laura A. Koziara, are husband and wife and were residents of Sterling Heights, Michigan, at the time their petition was filed herein. Laura A. Koziara is a petitioner herein solely because she joined with her husband Eugene H. Koziara in filing joint Federal income tax returns. Petitioner Aniela Koziara is the mother of Eugene H. Koziara and was a resident of Smiths Creek, Michigan, at the time her petition was filed.

In 1975, 1976, and 1977, petitioners Eugene H. and Aniela Koziara were the owners in joint tenancy of certain land in St. Clair County, Michigan. Under petitioners' land were located oil and gas deposits. The deposits were part of a larger reservoir of oil and gas deposits known as the Columbus Section 3 Saline-Niagaran Formation Pool (hereinafter sometimes referred to as the "Columbus 3 Pool"). Petitioners' land consisted of a total of 80 acres, including two 20-acre parcels referred to as tracts one and two, and a 40-acre parcel referred to as tract six. During 1975, 1976, and 1977, one well was located on tract two, and two wells were located on tract six. No wells were located on tract one.

Prior to September 14, 1963, the land was owned by petitioner Aniela Koziara and her husband, Frank, as tenants by the entirety. They entered into a lease agreement on March 16, 1961, with Joseph Adair ("Adair") under which Adair acquired the right to explore and drill for oil and gas on tracts one, two, and six, and under which Aniela and Frank Koziara reserved a royalty interest of 1/8 of the proceeds received from the oil and gas extracted. The land owned by Aniela and Frank Koziara was converted to a joint tenancy on September 14, 1963, and an interest therein was transferred by deed to Eugene H. Koziara.

Frank Koziara died in 1974. Thereafter, tracts one, two, and six have been owned by Eugene H. Koziara and Aniela Koziara. By 1975, the lease with Adair apparently had expired and Adolph Rovsek had become the lessee of the working interest in tract two. The Koziaras owned 100 percent of the royalty rights with respect to tract one and a royalty interest of 20.83 percent in tract two.

With respect to tract six, on May 21, 1968, Sun Oil Company acquired from Adair the rights Adair had under the March 16, 1961, lease to explore and drill for oil and gas on that tract. On November 4, 1971, the three Koziaras and Sun Oil Company amended the lease with respect to tract six, pursuant to which the royalty interest of the Koziaras was increased from 1/8 to 7/32. In November of 1971, the Koziaras conveyed to a third party not specified in the record herein an undivided 1/32 royalty interest in oil and gas extracted from tract six, leaving the Koziaras a royalty interest therein of 6/32.

In 1969 and 1970, the three parcels of oil-producing land owned by petitioners were the subject of an order issued by the Supervisor of Wells of the Michigan Department of Natural Resources. In 1969, the Michigan Supervisor of Wells, pursuant to the authority granted to him by Mich. Stat. Ann. § 13.139(1) through § 13.139(24) (Callaghan 1981), issued an order establishing 20-acre drilling units for all land that overlaid the Columbus 3 Pool and providing a uniform well-spacing pattern on that land. The purpose of that order was to provide for the orderly and efficient development of the reservoir of oil and gas in the Columbus 3 Pool. Another order, referred to as a "proration order," was issued by the Michigan Super-

visor of Wells effective February 1, 1970. The proration order limited extraction of oil from the Columbus 3 Pool to a maximum of 75 barrels per well per day.

On March 20, 1973, Sun Oil Company, as lessee of the working interest in tract six, requested the Michigan Supervisor of Wells to unitize all oil and gas deposits in the Columbus 3 Pool in order to improve the secondary recovery of oil and gas deposits in the reservoir. Unitization is a procedure authorized under Michigan law (see Mich. Stat. Ann. § 13.139(101) through § 13.139(144) (Callaghan 1981)), under which an owner of a working interest in a portion of a particular reservoir of oil and gas may be designated to be the sole person or entity with the right to extract oil and gas from the reservoir. The various land owners and owners of working interests in an oil and gas deposit affected by a unitization order are assigned percentage royalty interests in the oil and gas that is extracted from the reservoir by the individual or entity who is authorized to proceed therewith.

On June 20, 1973, the Michigan Supervisor of Wells issued a provisional order granting the request of Sun Oil Company for unitization of the Columbus 3 Pool. A permanent unitization order was issued on June 25, 1974, after Sun Oil Company had obtained written approval of the unitization plan from those who owned approximately 75 percent of the royalty rights to the oil and gas deposits in the Columbus 3 Pool.

Under the agreement entered into with respect to unitization of the oil and gas deposits in the Columbus 3 Pool, participants in the agreement were to receive payments of royalties according to a formula which reflected the size of the land parcel they owned over the Columbus 3 Pool (or the extent of

their working interest therein) and the extent to which oil and gas was extracted from their parcel during the fourth quarter of 1971.

On June 29, 1974, petitioners Eugene H. and Aniela Koziara and on July 5, 1974, Walter and Eleanor Wronski (who also owned land over the Columbus 3 Pool) appealed the unitization order to the Michigan Supervisor of Wells. They alleged that the royalty participation percentages provided in the unitization order were arbitrary and unreasonable, that the unitization order violated state and Federal statutes which prohibited monopolies and restraints of trade, and that the unitization order was unconstitutional. In subsequent documents filed with the Michigan Supervisor of Wells, they also alleged that Sun Oil Company extracted excess oil and gas from the Columbus 3 Pool during the years 1971 through 1974, that Sun Oil Company never had obtained the requisite 75-percent approval of the owners of the Columbus 3 Pool which was required prior to issuance of a unitization order, and that Sun Oil Company was not the proper party to request unitization of the Columbus 3 Pool. The Michigan Supervisor of Wells ruled against the appeal filed by the Koziaras and the Wronskis on the merits and on the ground that some of the allegations were untimely raised.

In April of 1975, the Koziaras and the Wronskis filed a lawsuit against Sun Oil Company in the Circuit Court for the County of St. Clair, Michigan, wherein they alleged that Sun Oil Company had extracted oil and gas from the Columbus 3 Pool in excess of that to which it was entitled under the unitization and proration orders. In that lawsuit, the circuit court found that Sun Oil Company had illegally extracted

150,000 barrels of oil from the Columbus 3 Pool, of which 1/3 or 50,000 barrels were attributable to the interests of the Koziaras and the Wronskis, and damages were imposed against Sun Oil Company based on a value for the excess oil extracted of $12.50 per barrel. On appeal, the Michigan Court of Appeals reversed the decision of the circuit court with respect to the amount of damages, holding that $5.02 per barrel was the proper measure of the excess oil extracted. Also, the court of appeals reversed the circuit court's award of punitive damages against Sun Oil Company. The appellate opinion is set forth at *Wronski* v. *Sun Oil Company*, 89 Mich. App. 11, 279 N.W.2d 564 (1979).

On February 28, 1979, the Koziaras and the Wronskis filed another action against Sun Oil Company — this time in the Circuit Court for the County of Ingham, Michigan. This action was based upon their allegation that the unitization order was obtained by Sun Oil Company without first obtaining the consents thereto of 75 percent of the owners of the affected land or of the holders of the working interests in the Columbus 3 Pool, and also on their allegation that their royalty participation percentages under the unitization order should have been higher. The circuit court dismissed the action without issuing a written opinion. The Koziaras and the Wronskis appealed that dismissal, and the Michigan Court of Appeals remanded the action to the circuit court for further hearings with respect to the effect on the computation of the royalty participation percentages of the extraction by Sun Oil Company of excess oil and gas from the reservoir during the fourth quarter of 1971.

In 1975, 1976, and 1977, Sun Oil Company made

payments under the unitization order to petitioners with respect to oil extracted from tracts two and six, as follows:

Year	*Payments*
1975	$212,764.14
1976	275,735.60
1977	213,347.80

For each of the above years, Sun Oil Company provided petitioners Forms 1099-MISC, reflecting the above amounts as royalty income.

On their 1975 and 1976 Federal income tax returns, both Eugene H. Koziara and Aniela Koziara reported the royalty payments received from Sun Oil Company as ordinary income. On their 1977 Federal income tax returns, petitioners reported the royalty payments as capital gain income because an involuntary conversion allegedly had occurred with respect to their interests in the Columbus 3 Pool by virtue of the unitization order. Petitioners subsequently filed amended 1975 and 1976 Federal income tax returns, claiming capital gain treatment with respect to the royalty payments they had received in those years.

The issue for decision is whether the unitization of petitioners' interests in the oil and gas deposits located in the Columbus 3 Pool constituted an involuntary conversion under section 1231, as petitioners contend, entitling them to treat the royalty payments received with respect thereto as capital gain income. Respondent's position is that no involuntary conversion within the meaning of section 1231 occurred and that royalty payments petitioners received from Sun Oil Company are to be treated as ordinary income. For the following reasons, we agree with respondent.

Royalty payments received with respect to the extraction of oil and gas or other minerals generally are taxable as ordinary income. *Burnet* v. *Harmel*, 287 U.S. 103 (1932); *Kittle* v. *Commissioner*, 21 T.C. 79 (1953), affd. 229 F.2d 313 (9th Cir. 1956). Section 1231(a)[2] provides however, among other things, that recognized gains from the compulsory or involuntary conversion of property used in a trade or business and capital assets held for more than six months (nine months in 1977) shall be treated as capital gain income. Section 1.1231-1(e), Income Tax Regs., defines involuntary conversion of property as follows:

> (e) *Involuntary conversion* — (1) *General rule.* For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of

---

[2] Sec. 1231(a), as applicable to the years in question, provides in part:

> (a) *General Rule.* — If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months [9 months in 1977] into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months [9 months in 1977]. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. • • •

> complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. • • •

Petitioners refer to the broad powers given to the Michigan Supervisor of Wells under the Michigan unitization statute (which powers include the right to modify or terminate all leases, contracts, and property rights of an owner)[3] in support of their contention that the unitization of their interests in the Columbus 3 Pool constituted an involuntary conversion, particularly in light of the fact that petitioners voted against unitization. Respondent argues that there has been no taking of petitioners' property sufficient to constitute an involuntary conversion, and that the unitization of petitioners' interests represented a regulation of the oil and gas deposits, not a condemnation or involuntary conversion thereof.

In *American National Gas Co.* v. *United States*, 279 F.2d 220 (Ct. Cl. 1960), cert. denied 364 U.S. 900 (1960), the terms "requisition or condemnation" were construed as they appeared in section 117 of the Internal Revenue Code of 1939, which is the predecessor statute to section 1231. In that case, the taxpayer contended that an involuntary conversion had occurred when it sold its stock in the Detroit Edison

---

[3] Mich. Stat. Ann. § 13.139(118) (Callaghan 1981), provides:

> *Amendment of instruments to conform to act. Sec. 18.* Property rights, leases, contracts and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of the act and to any valid and applicable plan of unitization or order of the supervisor made pursuant to this act.

Company pursuant to an order issued to it by the Securities and Exchange Commission (SEC). The court emphasized that the purpose of the Public Utility Holding Act of 1935, 49 Stat. 803, 15 U.S.C. § 79(a) et seq. (1982), pursuant to which the SEC had issued its order, was to protect the public welfare from perceived abuses in the operation of public utility holding companies, not to requisition or to condemn the taxpayer's property. The court explained the limitations of the terms "requisition or condemnation" as follows:

> Plaintiffs say that the term "requisition or condemnation" as used in the Act means something more than the exercise of the power of eminent domain. We do not think it does. It seems clear to us that the words mean the taking or the threat of taking property by some public or quasi-public corporation — by some instrumentality that has the power to do so against the will of the owner, and for the use of the taker. That is the common, well-recognized meaning of those words and there is nothing to indicate that Congress used them in any other sense. Plaintiffs were required to dispose of their property, but the United States did not take it, nor did it prevent plaintiffs from getting for it its full market value at the time of the taking. [*American Natural Gas Co.* v. *United States*, 279 F.2d at 225.]

The foregoing interpretation of the meaning of the terms "requisition or condemnation" was expressly approved by this Court in *Dorothy C. Thorpe Glass Mfg. Corp.* v. *Commissioner*, 51 T.C. 300, 305 (1968). In that case, an affiliated corporation leased from an unrelated third party a building that was adjacent to

petitioner's building. The affiliated corporation was threatened with legal action by a city attorney for violating a municipal ordinance with respect to the use of the leased building. It was determined for business reasons that petitioner and the affiliated corporation both would relocate their offices into a new building. Petitioner was denied nonrecognition treatment under section 1033 on the gain from the sale of its building on two grounds: (1) Petitioner had no legal interest in the adjacent real estate threatened by legal action, and (2) the threat of legal action did not constitute an involuntary conversion by "requisition or condemnation."

Michigan law expressly provides that the ownership of land and the interests affected by unitization remain unchanged. The relevant statute provides as follows:

> *Title to oil and gas rights in tracts in unit area. Sec. 15.* Except to the extent that the parties specifically so agree, no order for unit operations shall be construed to result in a transfer of all or any part of the title of any person to the oil and gas rights in any tract in the unit area. • • • [Mich. Stat. Ann. § 13.139(115) (Callaghan 1981).]

The purpose of Michigan's unitization law is to regulate the extraction of oil and gas so that the interests of various affected parties will be protected — not taken away. In the absence of such a regulatory scheme, a single land owner might be able to extract all oil and gas in a reservoir to the detriment of adjacent landowners. The Michigan unitization procedure represents a regulation of the extraction process in order to avoid such a result, not the exercise of the

power of eminent domain, nor does it constitute an involuntary conversion of property interests of the affected parties.

We note the similarities between this case and *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960). Therein, the U.S. government took over the operation of a common carrier during World War II, although ownership of the carrier was retained by the taxpayer who resumed operation of the business at the end of the war. A governmental claims commission awarded the taxpayer $122,926.21, representing the fair rental value of the business during the period the government operated it. The taxpayer contended that the $122,926.21 was received as the result of an involuntary conversion pursuant to section 117 (the predecessor statute to section 1231). The Supreme Court held, however, that the $122,926.21 was taxable as ordinary income because the government had not taken over ownership of the business, but only "the right to determine the use to which the [business] would be put." The Supreme Court also noted —

> The words "seizure" and "requisition" are not thereby deprived of effect, since they equally cover instances in which the Government takes a fee or damages or otherwise impairs the valufe of physical property. [364 U.S. at 136.]

In summary, we conclude that neither petitioners' land nor petitioners' rights to and interests in the oil and gas deposits under their land were the subject of an involuntary conversion, requisition, or condemnation or the threat thereof. The unitization order issued herein under Michigan law did not constitute the exercise of the state's power of eminent domain. The royalty payments petitioners received from Sun Oil

Company during the years in issue are properly taxable to them as ordinary income. Respondent's motion for summary judgment will be granted, and petitioners' motion for summary judgment will be denied.

Accordingly,

Appropriate orders and decisions will be entered under Rule 155.

APPENDIX C

ORDER

(United States Court of Appeals — for the Sixth Circuit)

(February 3, 1987)

(ANIELA KOZIARA (87-1054), EUGENE H. KOZIARA (87-1055), LAURA A. KOZIARA (87-1055), Petitioners-Appellants vs. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee — No. 87-1054/1055)

The Court having determined that consolidation of the above-styled causes for purposes of briefing and oral argument is appropriate,

It is ORDERED that the causes be and hereby are consolidated for purposes stated above.

ENTERED PURSUANT TO RULE 4(f)
SIXTH CIRCUIT RULES
John P. Hehman, Clerk
BY: /s/ Leonard Green
Chief Deputy Clerk

APPENDIX D

NOTICES OF APPEAL

(United States Tax Court)

(Dated January 2, 1987)

(EUGENE H. KOZIARA and LAURA A. KOZIARA, Petitioners, v. Commissioner of Internal Revenue, Respondent — Docket No. 10828-80)

Notice is hereby given that EUGENE H. KOZIARA and LAURA A. KOZIARA hereby appeal to the United States Court of Appeals for the 6th Circuit from the decision of this court entered in the above captioned proceeding on the 7th day of October, 1986, granting respondent's motion for summary judgment filed with the Court on October 19, 1984, and denying petitioner's motion for summary judgment filed with the Court on October 19, 1984.

NOTICE OF APPEAL

Notice is hereby given that ANIELA KOZIARA hereby appeals to the United States Court of Appeals for the 6th Circuit from the decision of this court entered in the above captioned proceeding on the 7th day of October, 1986, granting respondent's motion for summary judgment filed with the Court on October 19, 1984, and denying petitioner's motion for summary judgment filed with the Court on October 19, 1984.

/s/ ROBERT M. JUSTIN (P15630)
1142 North Main Street
Rochester, MI 48063

Dated: 1-2-87

APPENDIX E

STIPULATION OF FACTS

(United States Tax Court)

(Dated October 19, 1984)

(EUGENE H. KOZIARA and LAURA A. KOZIARA, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent — Docket No. 10828-80; ANIELA KOZIARA, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent — Docket No. 11321-80)

It is hereby stipulated that, for the purpose of the respondent's Motion for Summary Judgment, the following statements may be accepted as facts, except as qualified herein, and all exhibits referred to herein and attached hereto, are incorporated in this stipulation and made a part thereof.

1. The petitioners in Docket No. 10828-80, Eugene H. Koziara and Laura A. Koziara, are husband and wife, and at the time of the filing of their petition in Tax Court they resided at 11406 Savage Drive, Sterling Heights, Michigan, 48077.

2. The petitioner in Docket No. 11321-80, Aniela Koziara, resided at 8771 Alpine Road, Smiths Creek, Michigan, 48074, at the time of the filing of her petition in Tax Court.

3. Petitioner Aniela Koziara is the mother of petitioner Eugene Koziara.

4. Petitioners Eugene Koziara and Laura Koziara filed their federal income tax returns with the Internal

Revenue Service for the taxable years 1975, 1976 and 1977, which returns are attached hereto as Joint Exhibits 1-A, 2-B and 3-C, respectively.

5. Petitioner Aniela Koziara filed her federal income tax returns with the Internal Revenue Service for the taxable years 1975, 1976 and 1977, which returns are attached hereto as Joint Exhibits 4-D, 5-E and 6-F, respectively.

6. One common issue in these cases involves oil producing properties which are located in St. Clair County, Michigan. These properties overlie a pool of oil known as the Columbus Section 3 Saline-Niagaran Formation Pool (also referred to as Columbus 3 Pool). Attached hereto as Joint Exhibit 7-G is a copy of a document which sets forth the properties which are located over the Columbus 3 Pool.

7. During the years at issue, Aniela Koziara and Eugene Koziara, owned as joint tenants the following described property which was located over the Columbus 3 Pool:

> All that certain tract of land situated in the Township of Wales, County of St. Clair, State of Michigan, described as follows, to-wit: SW 1/4 of NW 1/4 and NE 1/4 of SW 1/4 of Section 34, Township 6N, Range 15E, and containing 80 acres.

8. A portion of the petitioners' property set forth in stipulated paragraph 7 above, consisted of two 20 acre plots which property is shown on Joint Exhibit 7-G as tract numbers 1 and 2.

9. The remaining portion of petitioners' property set forth in stipulated paragraph 7 above, consisted of 40 acre plot which is shown on Joint Exhibit 7-G as tract number 6.

10. The property set forth as tract numbers 1, 2 and 6 on Joint Exhibit 7-G was originally owned by Frank Koziara and Aniela Koziara, his wife, as tenants by the entirety.

11. Pursuant to a quit-claim deed dated September 14, 1963 this property (tract numbers 1, 2 and 6 on Joint Exhibit 7-G) was transferred from Frank Koziara and Aniela Koziara to Eugene H. Koziara, and Frank Koziara, and Aniela Koziara, his wife, in joint tenancy and not as tenants in common.

12. Frank Koziara died in 1974 and the property set forth as tract numbers 1, 2 and 6 on Joint Exhibit 7-G was thereafter owned by Eugene H. Koziara and Aniela Koziara, as joint tenants.

13. On March 17, 1961, Frank Koziara and Aniela Koziara entered into an oil and gas lease with Joseph Adair, in which Mr. Adair was given the right to mine and operate for oil and gas on the Koziaras' property set forth as tract numbers 1, 2 and 6 on Joint Exhibit 7-G. Frank and Aniela Koziara reserved a royalty interest of 1/8 of the proceeds of the production.

14. Sun Oil Company acquired from Joseph Adair the rights to mine and operate for oil and gas on tract number 6 on May 21, 1968.

15. On November 4, 1971, there was an amendment to the oil and gas lease between Frank Koziara, Aniela Koziara and Eugene Koziara, and Sun Oil Company with respect to tract number 6, whereby the royalty interest of the Koziaras was increased from 1/8 to 7/32.

16. In November of 1971 Frank Koziara, Aniela Koziara and Eugene Koziara transferred and conveyed to a third-party an undivided 1/32 royalty interest in

tract number 6 and thereafter the Koziaras owned a royalty interest in tract number 6 in the amount of 6/32 or 18.75 percent. The owner of the working interest in tract number 6 was Sun Oil Company.

17. Subsequent to June of 1973, the Koziaras owned a 100 percent royalty interest in their property shown on Joint Exhibit 7-G as tract number 1.

18. Subsequent to November 1, 1971, the Koziaras owned a royalty interest of 20.83 percent in their property shown on Joint Exhibit 7-G as tract number 2. The owner of the working interest in tract number 2 was Adolph Rovsek.

19. The Supervisor of Wells, Michigan Department of Natural Resources, pursuant to the authority granted him by Mich. Comp. Laws §§ 319.1 through 319.24; Mich. Stat. Ann. §§ 13.139(1) through 13.139(24); established 20-acre drilling units for the Columbus 3 Pool, and provided for a uniform well spacing pattern in 1969. The Supervisor of Wells Order of May 22, 1969 provided, in part, as follows:

> (B) DRILLING UNIT
> The drilling unit for wells drilled for oil and gas in the pool defined in (A) above shall be a tract of approximately 20 acres, rectangular in shape, found by dividing a governmental surveyed quarter-quarter section of land into an east half and a west half thereof.
>
> (C) WELL SPACING PATTERN
> Permits shall be granted for the drilling of wells for oil and gas in the pool defined in (A) above provided the wells are located in the center of the northeast one-quarter

(NE1/4) or the center of the southwest one-quarter (SW 1/4) of a governmental surveyed quarter-quarter section of land.

20. The purpose of the order entered by the Supervisor of Wells, as set forth in stipulated paragraph 19, was to prevent waste, protect correlative rights, and provide for orderly development of the pool.

21. The Supervisor of Wells, by a proration order effective February 1, 1970, further limited production in the Columbus 3 Pool to a maximum of 75 barrels per day per well. Mich. Comp. Laws § 319.13; Mich. Stat. Ann. § 13.139(13) authorizes the supervisor of wells to enter a proration order to prevent waste and to afford the owner of each property in the pool an opportunity to produce his just and equitable share of the oil and gas in the pool.

22. The petitioners had one operating well on tract number 2 and two operating well on tract number 6, which are shown on Joint Exhibit 7-G. These three wells were operating during the effective date of the proration order. Sun Oil Company was operating the two wells on tract number 6 and Adolph Rovsek was operating the well on tract number 2.

23. On March 20, 1973, Sun Oil Company requested that the Columbus 3 field be unitized to enable secondary recovery operations by pressure maintenance.

24. Unitization is a process which permits an entire field to be operated as a single entity without regard to surface boundary lines. When a field is unitized the owners of property within the drilling range are awarded a royalty interest in the whole of what is produced.

25. The Michigan statute which pertains to unitization, is known as the "Michigan Unitization Law" and is set forth in Mich. Comp. Laws §§ 319.351 through 319.394; Mich. Stat. Ann. §§ 13.139(101) through 13.139(144).

26. Mich. Comp. Laws § 319.357, Mich. Stat. Ann. § 13.139(107) provides as follows:

> No order of the supervisor providing for unit operations shall be declared or become effective until the plan for unit operations prescribed by the supervisor has been approved in writing by those persons who under the supervisor's order will be required to pay at least 75% of the costs of unit operations; and also those persons who are owners of record of at least 75% of the production or proceeds thereof that will be credited to interests which are free of costs such as but not limited to royalties, overriding royalties and production payments; and until the supervisor has made a finding, either in the order providing for unit operations or in the supplemental order as hereinafter provided, that the plan for unit operations has been so approved in writing.

27. On June 20, 1973, the Supervisor of Wells issued a provisional order granting the unitization request of Sun Oil Company. A permanent order was contingent upon Sun Oil Company obtaining written approval of the unitization plan from at least 75 percent of the owners of record as required by Mich. Comp. Laws § 319.357; Mich. Stat. Ann. § 13. 139(107).

28. Sun Oil Company submitted evidence to the Supervisor of Wels which indicated that 76.65132 per-

cent of the owners of interest in the Columbus 3 oil field had voted in favor of unitization. Attached hereto as Joint Exhibit 8-H, is a copy of a schedule prepared by Sun Oil Company which showed that the requisite 75 percent approval was obtained. Joint Exhibit 8-H shows the interest of the owners in the Columbus 3 Pool which was calculated by Sun Oil Company, and further indicates whether the ownership of that particular interest executed an agreement in favor of the unitization. Joint Exhibit 8-H indicates that owners with an interest of 76.65132 percent were in favor of unitization and owners with an interest in the amount of 23.34868 percent were against the unitization of the Columbus 3 field.

29. On June 25, 1974, the Supervisor of Wells found that Sun Oil Company had obtained the necessary 75 percent written consent by the owners and approved the unitization plan.

30. Petitioners' ownership of interest free of cost in the Columbus 3 Pool was determined to be 17.33183 percent and petitioners voted against unitization as set forth in Joint Exhibit 8-H.

31. Attached hereto as Joint Exhibits 9-I and 10-J are the "Unit Agreement" and "Unit Operating Agreement" respectively, with respect to the Columbus 3 unit. Sun Oil Company was the unit operator of the Columbus 3 unit.

32. As set forth in Joint Exhibit 9-I, which is the Unit Agreement with respect to the Columbus 3 unit, the tract participations of each tract set forth in Joint Exhibit 8-H, were determined based upon the following formula:

$$40\% \times \frac{\text{tract equivalent oil and gas acre feet}}{\text{total unit equivalent oil and gas acre feet}}$$

$$\text{plus } 60\% \times \frac{\text{tract oil production during fourth quarter 1971}}{\text{total unit oil production during fourth quarter 1971}}$$

33. During the taxable years 1975, 1976 and 1977, during which the unitization was in effect, Sun Oil Company paid petitioners the following royalty income with respect to their interest in the Columbus 3 unit. These payments were based on the petitioners' royalty interest in the oil and gas production allocated to petitioners' property by the tract participation set forth in stipulated paragraph 58.

Year	*Royalty Income*
1975	$212,764.14
1976	275,735.60
1977	213,347.80

34. During the taxable years 1975, 1976 and 1977, Sun Oil Company provided petitioners with a Form 1099-MISC, which set forth the royalty income paid to petitioners during the taxable years at issue.

35. Petitioners agree that 1/2 of the income in stipulated paragraph 33 above is attributable to Eugene Koziara, and 1/2 of the income in stipulated paragraph 33 is attributable to petitioner Aniela Koziara.

36. On the original 1975 and 1976 federal income tax returns filed by petitioner Aniela Koziara, she included royalty income paid by Sun Oil Company on her returns in the respective amounts of $106,382.07 and $137,867.80.

37. On the original 1975 and 1976 Federal income tax returns filed by petitioners Eugene and Laura Koziara, they included royalty income paid by Sun Oil Company on their returns in the respective amounts of $106,382.07 and $137,867.80.

38. On the 1977 federal income tax return of petitioner Aniela Koziara, she noted that she received royalty income of $106,673.90, but failed to include this amount in income for 1977 for the reasons set forth in stipulated paragraph 41. Petitioner Aniela Koziara filed amended 1975 and 1976 federal income tax returns claiming that the royalty income was not taxable as ordinary income. Attached hereto as Joint Exhibits 11-K and 12-L are copies of the 1975 and 1976 amended returns, respectively.

39. On the 1977 federal income tax returns of petitioners Eugene and Laura Koziara, they noted that they received royalty income of $106,673.90, but failed to include this amount in income for 1977, for the reasons set forth in stipulated paragraph 41. Petitioner Eugene Koziara filed amended 1975 and 1976 federal income tax returns claiming that the royalty income was not taxable as ordinary income. Attached hereto as Joint Exhibits 13-M and 14-N are copies of the 1975 and 1976 amended returns, respectively.

40. It is respondent's position that petitioners received royalty income in 1975, 1976 and 1977 in the following amounts which income is taxable as ordinary income:

Year	*Aniela Koziara*	*Eugene Koziara*
1975	$106,382.07	$106,382.07
1976	137,867.80	137,867.80
1977	106,673.90	106,673.90

The parties agree that the royalty income issue is only before the Court for Eugene Koziara for the taxable years 1976 and 1977, and that the royalty income issue is before the Court with respect to Aniela Koziara for the taxable years 1975, 1976 and 1977.

41. Petitioners contend that for the years before the Court the revenue set forth in stipulated paragraph 40 is subject to capital gain treatment because there was an involuntary conversion of their property pursuant to IRC 1231. First, petitioners contend that unitization without written agreement is condemnation. Second, petitioners contend that there was an involuntary conversion because a portion of their interest in the oil and gas in the Columbus 3 Pool was condemned pursuant to the Michigan Unitization Law which unitization was illegal because the required 75 percent approval was never obtained. Petitioners contend that the revenue received from Sun Oil Company was the compensation they received for their condemned property rights in the oil and gas.

42. Petitioners contend that a calculation of their tract participation in the Columbus 3 Pool by Sun Oil Company was improper because of the illegal overproduction of oil by Sun Oil Company during the fourth quarter of 1971. The oil production during the fourth quarter of 1971 was a factor in the computation of the tract participation in the Columbus 3 unit.

43. The petitioners filed suit in the Circuit Court for the County of St. Clair, State of Michigan, alleging damages based upon the overproduction of oil by Sun Oil Company. Attached hereto as Joint Exhibit 15-0 is a copy of the opinion filed by the St. Clair County Circuit Court with respect to this lawsuit.

44. The decision of the St. Clair County Circuit Court in awarding damages to petitioners for the overproduction of oil by Sun Oil Company was appealed to the Court of Appeals of Michigan. Attached hereto as Joint Exhibit 16-P is a copy of the opinion filed by the Court of Appeals of Michigan. The Court of Appeals affirmed the lower courts opinion that Sun Oil Company had produced 150,000 barrels of oil from the Columbus 3 Pool in violation of the order of the Supervisor of Wells, and that 50,000 barrels of this oil had been drained from the land of the Koziaras and Wronskis.

45. After the Supervisor of Wells approved the unitization on June 25, 1974, the Koziaras appealed the unitization order on June 29, 1974.

46. In April of 1975, the Koziaras and Wronskis (another owner in the Columbus 3 Pool) commenced litigation in the St. Clair County Circuit Court, alleging that Sun Oil Company was overproducing the Columbus 3 field, and converting oil in which they had a proprietary interest to its own use. The Court opinions with respect to this litigation are set forth above in stipulated paragraphs 43 and 44.

47. On November 18, 1975, the Koziaras and Wronskis petitioned the Supervisor of Wells to schedule a rehearing of the unitization order based upon Sun Oil's overproduction of the Columbus 3 field.

48. On December 17, 1975, the Supervisor of Wells denied the Koziaras' and Wronskis' petition on the basis that it was not timely and because the subject matter of the petition was covered in the pending appeal from the initial unitization order.

49. The Koziaras and Wronskis filed a second petition for rehearing on April 7, 1976. In this second petition it was alleged that Sun Oil Company had never obtained the 75 percent approval needed from owners of the field. The second petition to the Supervisor of Wells was denied for lack of timeliness.

50. On June 22, 1977, the Koziaras and Wronskis amended the basis of their original appeal to the Supervisor of Wells. The amended appeal charged, among other things, that Sun Oil Company had no standing to petition for unitization of the Columbus 3 field and had arbitrarily determined the owners' participation percentages. This petition filed with the Supervisor of Wells was subsequently denied.

51. The Koziaras and Wronskis subsequently commenced litigation in the Ingham County Circuit Court, State of Michigan, with respect to their allegations that the unitization was improper because the requisite 75 percent approval was never obtained and with respect to their argument that they had a greater participation interest in the Columbus 3 field. The Ingham County Circuit Court denied the petition filed by the Koziaras and Wronskis without issuing a written opinion.

52. The Koziaras and Wronskis appealed the decision of the Ingham County Circuit Court to the Michigan Court of Appeals. Attached hereto as Joint Exhibit 17-Q is a copy of the opinion of the Michigan Court of Appeals with respect to the appeal from the Ingham County Circuit Court.

53. Based upon the Court of Appeals opinion set forth in stipulated paragraph 52, the Ingham County Circuit Court remanded the case to the Department of

Natural Resources, Supervisor of Wells, for additional findings pursuant to the Court of Appeals opinion. Attached hereto as Joint Exhibit 18-R, is a copy of the Opinion And Order of Remand To The Department of Natural Resources, Supervisor of Wells, which was executed by Circuit Judge Carolyn Steel of the Ingham County Circuit Court. Pursuant to this remand to the Supervisor of Wells, it will be determined whether there was an overproduction of oil by Sun Oil Company in the fourth quarter of 1971, and whether such overproduction, if any, would change the participation percentages allocated to the Wronskis tract number 7 and to the Koziaras tract number 6 pursuant to the formula contained in the unitization agreement.

54. For the purposes of the summary judgment motion, respondent will stipulate that the overproduction of oil by Sun Oil Company resulted in the Koziaras and Wronskis having an increased tract participation in the Columbus 3 unit, to such an extent, that the Sun Oil Company did not receive the requisite 75 percent approval of the owners in the Columbus 3 unit, which is required pursuant to the Michigan Unitization Law. It is respondent's position in the summary judgment motion, that the character and nature of the ordinary royalty income received by petitioners during the years at issue based upon their participation in the Columbus 3 field as originally determined by Sun Oil Company, would not be altered or changed in any respect based upon the subsequent judicial determination that Sun Oil Company did not acquire the requisite 75 percent approval under the Michigan Unitization Law.

55. In the pending state litigation with Sun Oil Company regarding petitioners' allegation that they

had an increased participation in the Columbus 3 unit, the petitioners have asked for up to $20,000,000.00 in damages from Sun Oil Company for loss of revenue.

56. In the pending state litigation with Sun Oil Company which has now been remanded to the Department of Natural Resources, the petitioners are no longer seeking recission of the unitization based on the failure of Sun Oil Company to acquire the requisite 75 percent approval. Even though petitioners feel that unitization is improper, petitioners realize that to set aside the unitization order at this time would be in appropriate since it could result in inequities to other landowners and since it would result in waste by the failure to maximize recovery of oil from Columbus 3 Field. Petitioners only seek damages for loss of revenue as set forth in stipulated paragraph 55.

57. Pursuant to Mich. Comp. Laws § 319.357; Mich. Stat. Ann. § 13.139(107), which is set forth in stipulated paragraph 26, there is no dispute that Sun Oil Company obtained the written approval of the unitization from the persons required to pay at least 75% of the cost of unit operations, ie, the working interest owners.

58. The tract participation of each tract of property in the Columbus 3 Pool as determined by Sun Oil Company is set forth in Joint Exhibit 19-S, which is attached hereto. The tract participation of each tract was determined based on the formula set forth in stipulated paragraph 32. The tract participation of petitioners' property was determined to be as follows:

Tract Number	*Tract Participation Percentages*
1	.09324
2	3.03803
6	13.61672
Total	16.74799

59. The petitioners' ownership of interest free of costs in the Columbus 3 Pool as set forth in Joint Exhibit 8-H is computed based upon the petitioners' royalty interest in each of their tracts times the respective tract participation percentages divided by the sum of each royalty owners' interest times their respective tract participation interest. For example, the computation of petitioners' ownership of interest free of cost would be based on the following mathematical formula:

$$\text{Petitioner's Ownership of Interest} = \frac{(\text{RI tract 1} \times \text{Tract Participation in tract 1}) + (\text{RI tract 2} \times \text{Tract Participation in tract 2}) + (\text{RI tract 6} \times \text{Tract Participation in tract 6})}{\text{Sum of each RI in each tract times respective tract participation percentages.}}$$

RI = Royalty Interest

/s/ FRED T. GOLDBERG, JR.
Chief Counsel
Internal Revenue Service

By: /s/ PETER M. RITTEMAN
Assistant District Counsel
Internal Revenue Service
P.O. Box 32516
Detroit, Michigan 48232

/s/ ROBERT M. JUSTIN
Counsel for Petitioners
1142 N. Main
Rochester, Michigan 48063

[Dated:] *10-19-84*

APPENDIX F

STIPULATED EXHIBIT 8-H

OWNERSHIP OF INTEREST FREE OF COST

(Columbus Three Unit — St. Clair County, Michigan)

OWNER	*INTEREST*	*EXECUTED AGREEMENTS*	
		YES	*NO*
Eugene H. Koziara, Frank Koziara and Aniela Koziara, J/T	17.33183		X
Joseph Adair	.16618		X
Sam M. Myers	.49849		X
A. C. Martin	.49849	X	
Petroleum Reserve Corporation	.16618	X	
Petroleum Resources Company	.66467	X	
Helen Spalter	2.99243	X	
Maurice Shanahan & Madaleine Shanahan	4.55878	X	
Thomas E. Nolan	.10846		X
Walter Curzydlo & Agnes Curzydlo	18.08744	X	
Jack Whitney & Bonice K. Whitney	3.39141	X	
Patrick Petroleum Corporation and/or Patrick Oil and Gas Corporation	1.69568	X	

OWNER	*INTEREST*	*EXECUTED AGREEMENTS*	
		YES	*NO*
Manley, Bennett, McDonald and Company	.56521	X	
Walter F. Wronski & Eleanor J. Wronski	4.23190		X
Tatianna Romonow	.01789	X	
Basin Oil Company	1.78657	X	
Joe Beard	1.66039	X	
James Harman	.89328		X
Harold H. Winn & Mildred L. Winn	26.81482	X	
Charles F. Winn & Dorothy M. Winn	8.98256	X	
Walter Holowitz & Mrs. John Scoby, J/T	.47989	X	
S. L. Curtiss	.15691	X	
Floyd Phillip Hurry	.08965	X	
Oscar D. Long	.14569	X	
Harold M. McClure, Jr.	.38103	X	
Geraldine A. McClure	.21290	X	
Vance W. Orr	.29138	X	
G. D. Simon	.16808	X	
Robert M. Sheldon	.28022	X	
Walter Zimmerman	.07843	X	
William K. Roth	.08965	X	
Michel A. Cameron	.07843	X	

OWNER	*INTEREST*	*EXECUTED AGREEMENTS*	
		YES	*NO*
Robert G. Carnell	.07848	X	
James H. Fisher	.14569	X	
Donald W. Merritt	.04482		X
Floyd J. Winn & Pauline C. Winn	.32846	X	
Mike Lippstreuer	1.76391	X	
E. J. Fraley	.07372		X
TOTAL	100.00000	76.65132	23.34868

APPENDIX G

STIPULATED EXHIBIT 9-I
UNIT AGREEMENT

(Columbus Three Unit — St. Clair County, Michigan)

THIS AGREEMENT, Entered into as of the 1st day of July, 1972, by the parties who have signed the original of this instrument a counterpart thereof, or other instrument agreeing to be bound by the provisions hereof;

WITNESSETH:

WHEREAS, In the interest of the public welfare and to promote conservation and substantially increase the ultimate recovery of Unitized Substances from a portion of the Columbus Section "3" Field, located in St. Clair County, Michigan, and to protect the rights of the owners of interests therein, all in accordance with Michigan Act 197, Public Acts, 1959, as amended, it is deemed necessary and desirable to enter into this agreement to unitize the Oil and Gas Rights in and to the Unitized Formation in order to conduct Unit Operations as herein provided;

NOW, THEREFORE, In consideration of the premises and of the mutual agreements herein contained, it is agreed as follows:

ARTICLE 1
DEFINITIONS

As used in this agreement:

1.1 *Unit Area* is the land described by Tracts in Exhibit "A" and shown on Exhibit "B" as to which this agreement becomes effective or to which it may be extended.

1.2 *Unitized Formation* is the subsurface portion of the Unit Area known as the Niagaran Brown Dolomite Reservoir and described as shown on the Simultaneous Laterlog-Gamma Ray-Neutron log between 2924 feet and 3169 feet in the Maurice Shanahan No. 1 well located SW1/4 SE1/4 NW1/4 Section 34, T6N, R15E, St. Clair County, Michigan.

1.3 *Unitized Substances* are all oil, gas, gaseous substances, sulphur contained in gas, condensate, distillate, and all associated and constituent liquid or liquefiable hydrocarbons other than Outside Substances within or produced from the Unitized Formation.

1.4 *Working Interest* is an interest in Unitized Substances by virtue of a lease, operating agreement, fee title, or otherwise, including a carried interest, the owner of which interest is obligated to pay, either in cash or out of production or otherwise, a portion of the Unit Expense; however, Oil and Gas Rights that are free of lease or other instrument creating a Working Interest shall be regarded as a Working Interest to the extent of seven-eights (7/8) thereof and a Royalty Interest to the extent of the remaining one-eighth (1/8) thereof. A Royalty Interest created out of a Working Interest subsequent to the execution of this agreement by the owner of such Working Interest shall continue to be subject to such Working Interest burdens and obligations that are stated in this agreement and the Unit Operating Agreement.

1.5 *Royalty Interest* is a right to or interest in any portion of the Unitized Substances or proceeds thereof other than a Working Interest.

1.6 *Royalty Owner* is a party hereto who owns a Royalty Interest.

1.7 *Working Interest Owner* is a party hereto who owns a Working Interest.

1.8 *Tract* is the land described as such and given a Tract number in Exhibit "A".

1.9 *Unit Operating Agreement* is the agreement entered into by Working Interest Owners, having the same Effective Date as this agreement, entitled "Unit Operating Agreement, Columbus Three Unit, St. Clair County, Michigan."

1.10 *Unit Operator* is the Working Interest Owner designated by Working Interest Owners under the Unit Operating Agreement to conduct Unit Operations, acting as operator and not as a Working Interest Owner.

1.11 *Tract Participation* is the percentage shown on Exhibit "A" for allocating Unitized Substances to a Tract.

1.12 *Unit Participation* of a Working Interest Owner is the sum of the percentages obtained by multiplying the Working Interest of such Working Interest Owner in each Tract within the Unit Area by the Tract Participation of such Tract.

1.13 *Outside Substances* are substances other than Unitized Substances which are injected into the Unitized Formation.

1.14 *Oil and Gas Rights* are the rights to explore, develop and operate lands within the Unit Area for the production of Unitized Substances, or to share in the production so obtained or the proceeds thereof.

1.15 *Unit Operations* are all operations conducted pursuant to this agreement and the Unit Operating Agreement.

1.16 *Unit Equipment* is all personal property, lease and well equipment, plants and other facilities and equipment taken over or otherwise acquired for the joint account for use in Unit Operations.

1.17 *Unit Expense* is all cost, expense or indebtedness incurred by Working Interest Owners or Unit Operator pursuant to this agreement and the Unit Operating Agreement for or on account of Unit Operations.

1.18 *Effective Date* is the time and date this agreement becomes effective as provided in Section 17.1.

1.19 *Supervisor* means Supervisor of wells as provided in Act No. 61 of the Public Acts of 1939, being Sections 319.1 to 319.27 of the Compiled Laws of 1948, as amended.

ARTICLE 2
EXHIBITS

2.1 *Exhibits.* The following exhibits, which are attached hereto, are incorporated herein by reference:

2.1.1 Exhibit "A" is a schedule that describes each Tract in the Unit Area and shows its Tract Participation.

2.1.2 Exhibit "B" is a map that shows the boundary lines of the Unit Area and the Tracts therein.

2.2 *Reference to Exhibits.* When reference is made to an exhibit, it is to the exhibit as originally attached or, if revised, to the last revision.

2.3 *Exhibits Considered Correct.* Exhibits "A" and "B" shall be considered to be correct until revised as herein provided.

2.4 *Correcting Errors.* The shapes and descriptions of the respective Tracts have been established by using the best information available. If it subsequently appears that any Tract, because of diverse royalty or working interest ownership on the Effective Date, should have been divided into more than one Tract, or that any mechanical miscalculation or clerical error has been made, Unit Operator, with the approval of Working Interest Owners and the Supervisor of Wells of the State of Michigan, shall correct the mistake by revising the exhibits to conform to the facts. The revision shall not include any re-evaluation of engineering or geological interpretations used in determining Tract Participation. Each such revision of an exhibit made prior to thirty (30) days after the Effective Date shall be effective as of the Effective Date. Each such revision thereafter made shall be effective at 7:00 a.m. on the first day of the calendar month next following the filing for record of the revised exhibit or on such other date as may be determined by Working Interest Owners and set forth in the revised exhibit.

2.5 *Filing Revised Exhibits.* If an exhibit is revised, Unit Operator shall execute an appropriate instrument with the revised exhibit attached and file the same for record in the county or counties in which this agreement is filed and with the Supervisor of Wells of the state of Michigan.

ARTICLE 3
CREATION AND EFFECT OF UNIT

3.1 *Oil and Gas Rights Unitized.* All Oil and Gas Rights of Royalty Owners in and to the lands described in Exhibit "A", and all Oil and Gas Rights of Working Interest Owners in and to said lands, are

hereby unitized insofar as the respective Oil and Gas Rights pertain to the Unitized Formation, so that Unit Operations may be conducted with respect to the Unitized Formation as if the Unit Area had been included in a single lease executed by all Royalty Owners, as lessors, in favor of all Working Interest Owners, as lessees, and as if the lease contained all of the provisions of this agreement.

3.2 *Personal Property Excepted.* All lease and well equipment, materials and other facilities heretofore or hereafter placed by any of the Working Interest Owners on the lands covered hereby shall be deemed to be and shall remain personal property belonging to and may be removed by Working Interest Owners. The rights and interests therein as among Working Interest Owners are set forth in the Unit Operating Agreement.

3.3 *Amendment of Leases and Other Agreements.* The provisions of the various leases, agreements, division and transfer orders, or other instruments pertaining to the respective Tracts or the production therefrom are amended to the extent necessary to make them conform to the provisions of this agreement, but otherwise shall remain in effect.

3.4 *Continuation of Leases and Term Interests.* Production from any part of the Unitized Formation, except for the purpose of determining payments to Royalty Owners, or other Unit Operations shall be considered as production from or operations upon each Tract, and such production or operations shall have the same effect under the terms of each lease or mineral or royalty interest grant as to all lands and formations covered thereby just as if such operations were conducted on and as if a well were producing from each Tract.

3.5 *Titles Unaffected by Unitization.* Nothing herein shall be construed to result in the transfer of title to Oil and Gas Rights by any party hereto to any other party or to Unit Operator.

3.6 *Injection Rights.* Working Interest Owners are Granted the right to inject into the Unitized Formation any substances in whatever amounts Working Interest Owners deem expedient for Unit Operations, together with the right to drill, use and maintain injection wells on the Unit Area, and to use for injection purposes any nonproducing or abandoned wells or dry holes, and any producing wells completed in the Unitized Formation without liability for damage to the Unitized Formation.

3.7 *Development Obligation.* Nothing herein shall relieve Working Interest Owners from any obligation to develop reasonably as a whole the lands and leases committed hereto.

ARTICLE 4
PLAN OF OPERATIONS

4.1 *Unit Operator.* Sun Oil Company (Delaware) is designated as the initial Unit Operator. Unit Operator shall have the exclusive right to conduct Unit Operations. The operations shall conform to the provisions of this agreement and the Unit Operating Agreement. If there is any conflict between such agreements, this agreement shall govern.

4.2 *Method of Operation.* To the end that the quantity of Unitized Substances ultimately recoverable may be increased and waste prevented, Working Interest Owners shall, with diligence and in accordance with good engineering and production practices, engage in such secondary recovery, pressure mainte-

nance or other recovery program as to Working Interest Owners may be deemed feasible, necessary or desirable to efficiently and economically increase the ultimate recovery of Unitized Substances.

4.3 *Change of Method of Operation.* Nothing herein shall prevent Working Interest Owners from discontinuing or changing in whole or in part any method of operation which, in their opinion, is no longer in accord with good engineering or production practices. Other methods of operation may be conducted or changes may be made by Working Interest Owners from time to time if determined by them to be feasible, necessary or desirable to increase the ultimate recovery of Unitized Substances.

ARTICLE 5
TRACT PARTICIPATIONS

5.1 *Tract Participations.* The Tract Participation of each Tract, as shown in Exhibit "A", on the effective date hereof and thereafter shall be based on the following factors and formula:

$$40\% \times \frac{\text{Tract Equivalent Oil and Gas Acre-feet}}{\text{Total Unit Equivalent Oil and Gas Acre-feet}}$$

$$\text{plus } 60\% \times \frac{\text{Tract Oil Production during Fourth Quarter 1971}}{\text{Total Unit Oil Production during Fourth Quarter 1971}}$$

5.2 *Relative Tract Participations.* If the Unit Area is changed, the revised Tract Participations of the Tracts remaining in the Unit Area and which were within the Unit Area prior to the change shall remain in the same ratio one to another.

ARTICLE 6
ALLOCATION OF UNITIZED SUBSTANCES

6.1 *Allocation to Tracts.* All Unitized Substances produced, saved and sold shall be allocated to the several Tracts in accordance with the respective Tract Participations effective during the period that the Unitized Substances were produced. The amount of Unitized Substances allocated to each Tract, regardless of whether the amount is more or less than the actual production of Unitized Substances from the well or wells, if any, on such Tract, shall be deemed for all purposes to have been produced from such Tract.

6.2 *Distribution Within Tracts.* The Unitized Substances allocated to each Tract shall be distributed among, or accounted for to, the parties entitled to share in the production of such Tract in the same manner, in the same proportions, and upon the same conditions as they would have participated and shared in the production from such Tract, or in the proceeds thereof, had this agreement not been entered into, and with the same legal effect. If any Oil and Gas Rights in a Tract hereafter become divided and owned in severalty as to different parts of the Tract, the owners of the divided interests, in the absence of an agreement providing for a different division, shall share in the Unitized Substances allocated to the Tract, or in the proceeds thereof, in proportion to the surface acreage of their respective parts of the Tract. Any royalty or other payment which depends upon per well production or pipe line runs from a well or wells on a Tract shall, after the Effective Date, be determined by dividing the Unitized Substances allocated to the Tract by the number of wells on the Tract

capable of producting Unitized Substances on the Effective Date; however, if any Tract has no well thereon capable of producing Unitized Substances on the Effective Date, the Tract shall, for the purpose of this determination, be deemed to have one such well thereon.

6.3 *Taking Unitized Substance in Kind.* The Unitized Substances allocated to each Tract shall be delivered in kind to the respective parties entitled thereto by virtue of the ownership of Oil and Gas Rights therein or by purchase from such owners. Such parties shall have the right to construct, maintain and operate within the Unit Area all necessary facilities for that purpose, provided they are so constructed, maintained and operated as not to interfere with Unit Operations. Any extra expenditures incurred by Unit perator by reason of the delivery in kind of any portion of Unitized Substances shall be borne by the owner of such proportion. If a Royalty Owner has the right to take in kind a share of Unitized Substances and fails to do so, the Working Interest Owner whose Working Interest is subject to such Royalty Interest shall be entitled to take in kind such share of Unitized Substances.

6.4 *Failure to Take in Kind.* If any party fails to take in kind or separately dispose of such party's share of Unitized Substances, Unit Operator shall have the right, but not the obligation, for the time being and subject to revocation at will by the party owning the share, to purchase or sell to others such share; however, all contracts of sale by Unit Operator of any other party's share of United Substances shall be only for such reasonable periods of time as are consistent

with the minimum needs of the industry under the circumstances, but in no event shall any such contract be for a period in excess of one year. The proceeds of the Unitized Substances so disposed of by Unit Operator shall be paid to the Working Interest Owners of each affected Tract or a party designated by such Working Interest Owners who shall distribute such proceeds to the parties entitled thereto. Notwithstanding the foregoing, Unit Operator shall not make a sale into interstate commerce of any other party's share of gas production without first giving such other party sixty (60) days' notice of such intended sale.

6.5 *Responsibility for Royalty Settlements.* Any party receiving in kind or separately disposing of all or part of the Unitized Substances allocated to any Tract shall be responsible for the payment of all royalties, overriding royalties, production payments, and all other payments chargeable against or payable out of such Unitized Substances, and shall indemnify all parties hereto, including Unit Operator, against any liability for such payment.

6.6 *Royalty on Outside Substances.* If any Outside Substance consisting of natural gases, including casinghead gas, but not limited hereto, is injected into the Unitized Formation, seventy-five percent (75%) of any like substance contained in Unitized Substances subsequently produced and sold, or used for other than Unit Operations, shall be deemed to be a part of the Outside Substance so injected until the total volume deemed to be such Outside Substance equals the total volume of such Outside Substance so injected. If any Outside Substance which prior to injection is liquefied petroleum gas or other liquid

hydrocarbons is injected into the Unitized Formation, ten percent (10%) of all Unitized Substances produced and sold after one (1) year from the time the injection of such Outside Substance was commenced shall be deemed to be a part of the Outside Substance so injected into the total value of the production deemed to be such Outside Substance equals the total cost of the Outside Substance so injected. Such ten percent (10%) of the Unitized Substances deemed to be Outside Substances will be in addition to that which is being recovered for natural gases as hereinabove provided, if both liquefied petroleum gas or other liquid hydrocarbons and natural gases are injected. No payment shall be due or payable to Royalty Owners on substances produced from the Unitized Formation that are deemed Outside Substances.

6.7 *Lien.* The Unit shall have a first and prior lien upon the lease-held interest and other Oil and Gas Rights (exclusive of a 1/8 royalty interest) in and to each Tract, the interest of the owners thereof in and to the Unitized Substances and all Unit Equipment in possession of the Unit, to secure payment of all Unit Expense properly charged to and against such Tract; provided that, such lien may be enforced against overriding royalty interests, or other interests that are otherwise not chargeable with such costs and expenses, only in the event the owner of the interest or interest primarily responsible fails to pay such Unit Expense when due, and the Unitized Substances to the credit thereof are insufficient for that purpose. If the owner of any royalty interest, overriding royalty, oil and gas payment, or other interest which under this Unit Agreement is not primarily responsible therefore pays any part of such Unit Expense for the purpose of pro-

tecting such interest, or if the amount of such Unit Expense is whole or in part is deducted from the Unitized Substances credited to such interest, the owner shall, to the extent of such payment or deduction, be subrogated to all of the rights of the Unit and of the Unit Operator with respect to the interest primarily chargeable with such Unit Expense. A one-eighth (1/8) part of the Unitized Substances allocated to each Tract shall in all events be regarded as royalty to be distributed to and among, or the proceeds thereof paid to, the basic Royalty Owners free and clear of all Unit Expense and free of any lien. The lien herein provided shall be for the use, benefit, and protection of the Unit Operator or other Persons entitled to receive or share in the monies, the payment of which is secured thereby, and upon a failure of the Unit to enforce such lien, the Unit Operator or other person entitled to the benefit thereof shall be subrogated to the lien rights of the Unit, including the right of foreclosure. The lien may be foreclosed at any time in the matter provided by law.

ARTICLE 7
PRODUCTION AS OF THE EFFECTIVE DATE

7.1 *Oil or Liquid Hydrocarbons in Lease Tanks.* Unit Operator shall gauge or otherwise determine the amount of merchantable oil or other liquid hydrocarbons produced from the Unitized Formation that are in lease and power-oil tanks as of 7:00 a.m. on the Effective Date. Oil or other liquid hydrocarbons in treating vessels, separation equipment, and tanks below pipe line connections shall not be considered to be merchantable. Any merchantable oil or other liquid hydrocarbons that are a part of or attributable

to the prior allowable of the wells from which they were produced shall remain the property of the parties entitled thereto as if this agreement had not been entered into. Any such merchantable oil or other liquid hydrocarbons not promptly removed may be sold by Unit Operator for the account of the Working Interest Owners entitled thereto who shall pay all royalty due thereon under the provisions of applicable leases or other contracts. Any oil or liquid hydrocarbons in excess of that attributable to the prior allowable of the wells from which they were produced shall be regarded as Unitized Substances produced after the Effective Date.

7.2 *Overproduction.* If, as of the Effective Date, any Tract is overproduced with respect to the allowable of the wells on that Tract, and if the amount of overproduction has been sold or otherwise disposed of, such overproduction shall be regarded as a part of the Unitized Substances produced after the Effective Date and shall be charged to such Tract as having been delivered to the parties entitled to Unitized Substances allocated to such Tract.

ARTICLE 8
USE OR LOSS OF UNITIZED SUBSTANCES

8.1 *Use of Unitized Substances.* Working Interest Owners may use or consume Unitized Substances for Unit Operations, including but not limited to the injection thereof into the Unitized Formation.

8.2 *Royalty Payments.* No royalty, overriding royalty, production or other payments shall be made payable on account of Unitized Substances used, lost or consumed in Unit Operations.

ARTICLE 9
TRACTS TO BE INCLUDED IN UNIT

9.1 *Qualification of Tracts.* On the Effective Date, the Unit Area will be composed of the Tracts listed in Exhibit "A".

ARTICLE 10
TITLES

10.1 *Warranty and Indemnity of Titles.* Each person who may claim to own a Working Interest or Royalty Interest in and to any Tract or the Unitized Substances allocated thereto, shall be deemed to have warranted its title to such interest, and, upon receipt of the Unitized Substances or the proceeds thereof to the credit of such interest, shall indemnify and hold harmless all other persons in interest from any loss due to failure, in whole or in part, of its title to any such interest.

10.2 *Production Where Title Is In Dispute.* If the title or right of any party claiming the right to receive in kind all or any portion of the Unitized Substances allocated to a Tract is in dispute, Unit Operator at the direction of Working Interest Owners shall either:

(a) require that the party to whom such Unitized Substances are delivered or to whom the proceeds thereof are paid furnish security for the proper accounting therefor to the rightful owner if the title or right of such party fails in whole or in part, or

(b) withhold and market the portion of Unitized Substances with respect to which title or right is in dispute, and

impound the proceeds thereof until such time as the title or right thereto is established by a final judgement of a court of competent jurisdiction or otherwise to the satisfaction of Working Interest Owners, whereupon the proceeds so impounded shall be paid to the party rightfully entitled thereto.

10.3 *Payment of Taxes to Protect Title.* The owner of surface rights to lands within the Unit Area, or severed mineral interests or Royalty Interests in such lands, or lands outside the Unit Area on which Unit Equipment is located, is responsible for the payment of any ad valorem taxes on all such rights, interests or property, unless such owner and Working Interest Owners otherwise agree. If any ad valorem taxes are not paid by or for such owner when due, Unit Operator may, with approval of Working Interest Owners, at any time prior to tax sale, or expiration of period of redemption after tax sale, pay the tax, redeem such rights, interests or property, and discharge the tax lien. Any such payment shall be an item of Unit Expense. Unit Operator shall, if possible, withold from any proceeds derived from the sale of Unitized Substances otherwise due any delinquent taxpayer an amount sufficient to defray the cost s of such payment or redemption, such withholding to be credited to Working Interest Owners. Such withholding shall be without prejudice to any other remedy available to Unit Operator or Working Interest Owners.

ARTICLE 11
EASEMENTS OR USE OF SURFACE

11.1 *Grant of Easements.* The parties hereto, to the extent of their rights and interests, hereby grant

to Working Interest Owners the right to use as much of the surface land within the Unit Area as may be reasonably necessary for Unit Operations and the removal of Unitized Substances from the Unit Area; however, nothing herein shall be construed as leasing or otherwise conveying to Working Interest Owners a camp site or a plant site for water injection, gas injection, or gas processing.

11.2 *Use of Water.* Working Interest Owners shall have and are hereby granted free use of water from the Unit Area, for Unit Operations, except water from any well, lake, pond or irrigation ditch of a Royalty Owner.

11.3 *Surface Damage.* Working Interest Owners shall pay the owner for damages to growing crops, timber, fences, improvements and structures on the Unit Area that result from Unit Operations.

ARTICLE 12
CHANGES AND AMENDMENTS

12.1 *Changes and Amendments.* Any change in the Unit Area or any amendment of the Unit Agreement or Unit Operating Agreement shall be according to the provisions of Michigan Act 197, Public Acts, 1959, as amended.

ARTICLE 13
TRANSFER OF TITLE

13.1 *Transfer of Title.* Any conveyance of all or any part of any interest owned by any party hereto with respect to any Tract shall be made expressly subject to this agreement. No change of title shall be binding upon Unit Operator, or upon any party hereto other than the party so transferring, until 7:00 a.m. on the first day of the calendar month next succeeding the

date of receipt by Unit Operator of a photocopy, or a certified copy, of the recorded instrument evidencing such change in ownership.

ARTICLE 14
RELATIONSHIP OF PARTIES

14.1 *No Partnership.* The duties, obligations and liabilities of the parties hereto are intended to be several and not joint or collective. This agreement is not intended to create, and shall not be construed to create, an association or trust, or to impose a partnership duty, obligation or liability with regard to any one or more of the parties hereto. Each party hereto shall be individually responsible for its own obligations as herein provided.

14.2 *No Joint Refining or Marketing.* This agreement is not intended to provide, and shall not be construed to provide, directly or indirectly, for any joint refining or marketing of Unitized Substances.

14.3 *Royalty Owners Free of Costs.* This agreement in not intended to impose, and shall not be construed to impose, upon any Royalty Owner any obligation to pay Unit Expense unless such Royalty Owner is otherwise so obligated.

ARTICLE 15
LAWS AND REGULATIONS

15.1 *Laws and Regulations.* This agreement shall be subject to all applicable federal, state and municipal laws, rules, regulations and orders.

ARTICLE 16
FORCE MAJEURE

16.1 *Force Majeure.* All obligations imposed by this agreement on each party, except for the payment

of money, shall be suspended while compliance is prevented, in whole or in part, by a labor dispute, fire, war, civil disturbance, act of God; by federal, state or municipal laws; by any rule, regulation or order of a governmental agency; by inability to secure materials; or by any other cause or causes, whether similar or dissimilar, beyond reasonable control of the party. No party shall be required against its will to adjust or settle any labor dispute. Neither this agreement nor any lease or other instrument subject hereto shall be terminated by reason of suspension of Unit Operations due to any one or more or the causes set forth in this Article.

ARTICLE 17
EFFECTIVE DATE

17.1 *Effective Date.* Unit Operator shall proceed to make plans and preparations and take such steps as are necessary for the taking over or the operations and further development of the Unit Area by the Unit. At any time after the Unit Agreement and Unit Operating Agreement has beeen approved by 75% of the Working Interest and Royalty Owners having an interest in the Unit Area, or at any time after the Supervisor's order, approving the Unit Agreement and Unit Operating Agreement is entered, the Unit Operator shall determine when the Unit will take over and commence Unit Operations.

17.2 *Ipso Facto Termination.* If the requirements of Section 17.1 are not accomplished on or before January 1, 1974, this agreement shall ipso facto terminate on that date (hereinafter called "termination date") and thereafter be of no further effect, unless prior thereto Working Interest Owners owning a combined Unit Participation of at least fifty percent (50%)

have become parties to this agreement and Working Interest Owners owning eighty percent (80%) or more of that percent have decided to extend the termination date for a period not to exceed six (6) months. If the termination date is so extended and the requirements of Section 17.1 are not accomplished on or before the extended termination date, this agreement shall ipso facto terminate on the extended termination date and thereafter be of no further effect. For the purpose of this section, Unit Participation shall be as calculated on the basis of Tract Participations shown on the original Exhibit "A".

17.3 *Certificate of Effectiveness.* Unit Operator shall file for record in the county or counties in which the land affected is located and with the Supervisor, if required, a certificate of effectiveness stating the Effective Date.

ARTICLE 18
TERM

18.1 *Term.* The term of this agreement shall be for the time that Unitized Substances are produced in paying quantities or other Unit Operations are conducted without a cessation of more than ninety (90) consecutive days, unless sooner terminated by Working Interest owners in the manner herein provided.

18.2 *Termination by Working Interest Owners.* This agreement may be terminated by Working Interest Owners owning a combined Unit Participation of eighty percent (80%) or more whenever such Working Interest Owners determine that Unit Operations are no longer profitable or feasible.

18.3 *Effects of Termination.* Upon termination of this agreement, the further development and operation of the Unitized Formation as a unit shall be abandoned, and Unit Operations shall cease. Each oil and gas lease and other agreements covering lands within the Unit Area shall remain in force for ninety (90) days after the date on which this agreement terminates, and for such further period as is provided by the lease or other agreements.

18.4 *Salvaging Equipment upon Termination.* If not otherwise granted by the leases or other instruments affecting each Tract, Royalty Owners hereby grant Working Interest Owners a period of six (6) months after the date of termination of this agreement within which to salvage and remove Unit Equipment.

18.5 *Certificate of Termination.* Upon termination of this agreement, Unit Operator shall file for record in the county or counties in which the land is located and with the Supervisor, if required, a certificate that this agreement has terminated, stating its termination date.

ARTICLE 19
EXECUTION

19.1 *Original, Conterpart or Other Instrument.* An owner of Oil and Gas Rights may become a party to this agreement by signing the original of this instrument, a counterpart thereof, or other instrument agreeing to become a party hereto. The signing of any such instrument shall have the same effect as if all parties had signed the same instrument.

19.2 *Joinder in Dual Capacity.* Execution as herein provided by any party as either a Working Interest Owner or a Royalty Owner shall commit all interests owned or controlled by such party.

ARTICLE 20
GENERAL

20.1 *Amendments Affecting Working Interest Owners.* Amendments hereto relating wholly to Working Interest Owners may be made if signed by all Working Interest Owners.

20.2 *Action by Working Interest Owners.* Except as otherwise provided in this agreement, any action or approval required by Working Interest Owners hereunder shall be in accordance with the provisions of the Unit Operating Agreement.

20.3 *Lien and Security Interest of Unit Operator.* Unit Operator shall have a lien upon and a security interest in the interests of Working Interest Owners in the Unit Area as provided in the Unit Operating Agreement.

ARTICLE 21
SUCCESSORS AND ASSIGNS

21.1 *Successors and Assigns.* The provisions hereof shall be covenants running with the lands, leases, and interests covered hereby, and shall be binding upon and inure to the benefit of the respective heirs, devisees, legal representatives, successors and assigns of the parties hereto.

IN WITNESS WHEREOF, The parties hereto have executed this agreement on the dates opposite their respective signatures.

WORKING INTEREST OWNERS

SUN OIL COMPANY (DELAWARE)
By: /s/ V.L. Smith, Attorney in Fact

/s/ [*Illegible*], Witness
Date: *7/10/72*

/s/ [*Illegible*], Witness
Date: *7/10/72*

(*Jurat Omitted*)

EXHIBIT "A" TO UNIT AGREEMENT

(Columbus Three Unit — St. Clair County, Michigan)

TRACTS AND TRACT PARTICIPATION PERCENTAGES

Tract No.	*Tract Name*	*Description*	*Tract Participation*
1	E. Koziara	W 1/2 SW 1/4 NW 1/4 of Section 34-T6N-R15E	.09324
2	E. Koziara	E 1/2 SW 1/4 NW 1/4 of Section 34-T6N-R15E	3.03803
3	M. Shanahan	W 1/2 SE 1/4 NW 1/4 of Section 34-T6N-R15E	6.56866
4	Shanahan & Nolan	E 1/2 SE 1/4 NW 1/4 of Section 34-T6N-R15E	.32011
5	W. Curzydlo	E 1/2 SW 1/4 SW 1/4 & NW 1/4 SW 1/4 of Section 34-T6N-R15E	13.34844
6	F. Koziara	NE 1/4 SW 1/4 of Section 34-T6N-R15E	13.61672
7	W.F. Wronski	W 1/2 SE 1/4 of Section 34-T6N-R15E	6.07530
8	T. Romanow	W 1/2 SW 1/4 SW 1/4 of Section 34-T6N-R15E	.02020
9	H.H. Winn "C"	SE 1/4 SW 1/4 of Section 34-T6N-R15E	10.54787
10	T. Romanow	E 1/2 W 1/2 NW 1/4 of Section 3-T5N-R15E	.00622
11	F. Holowitz, et al	W 1/2 E 1/2 NW 1/4 of Section 3-T5N-R15E	.70834
12	H.H. Winn, et al	E 1/2 SW 1/4 & E 1/2 E 1/2 NW 1/4 & W 1/2 W 1/2 NE 1/4 of Section 3-T5N-R15E	31.93710

Tract No.	*Tract Name*	*Description*	*Tract Participation*
13	W.F. Wronski	E 1/2 W 1/2 NE 1/4 of Section 3-T5N-R15E	.17093
14	F.J. Winn	W 1/2 SW 1/4 of Section 3-5N-15E	.00932
15	H.H. Winn "B"	W 1/2 SE 1/4 of Section 3-T5N-R15E	10.35168
16	F.J. Winn "B"	NW 1/2 NW 1/4 of Section 10-5N-15E	.47551
17	Lippstreuer	NE 1/4 NW 1/4 of Section 10-T5N-R15E	2.60356
18	E.J. Fraley	W 1/2 NW 1/4 NE 1/2 of Section 10-5N-15E	.10877
			100.00000

APPENDIX H

STIPULATED EXHIBIT 10-J

UNIT OPERATING AGREEMENT

(Columbus Three Unit — St. Clair County, Michigan)

THIS AGREEMENT, entered into as of the 1st day of July, 1972, by the parties who have signed the original instrument, a counterpart thereof, or other instrument agreeing to be bound by the provisions hereof;

WITNESSETH:

WHEREAS, the parties hereto as Working Interest Owners have executed, as of the date hereof, an agreement entitled, "Unit Agreement, Columbus Three Unit, St. Clair County, Michigan," herein referred to as "Unit Agreement," which, among other things, provides for a separate agreement to be entered into by Working Interest Owners to provide for the development and operation of the Unit Area as therein defined;

NOW, THEREFORE, in consideration of the mutual agreements herein set forth, it is agreed as follows:

ARTICLE 1
CONFIRMATION OF UNIT AGREEMENT

1.1 *Confirmation of Unit Agreement.* The Unit Agreement is hereby confirmed and by reference made a part of this agreement. The definitions in the Unit Agreement are adopted for all purposes of this agreement. If there is any conflict between the Unit Agreement and this Agreement, the Unit Agreement shall govern.

ARTICLE 2
EXHIBITS

2.1 *Exhibits.* The following exhibits are incorporated herein by reference:

2.1.1 Exhibits A and B of the Unit Agreement

2.1.2 Exhibit C, attached hereto, which is the Accounting Procedure applicable to Unit Operations. If there is any conflict between this agreement, and Exhibit C, this Agreement shall govern.

2.1.3 Exhibit D, attached hereto, which contains insurance provisions applicable to Unit Operations.

ARTICLE 3
SUPERVISION OF OPERATIONS BY WORKING INTEREST OWNERS

3.1 *Overall Supervision.* Working Interest Owners shall exercise overall supervision and control of all matters pertaining to Unit Operations pursuant to this agreement and the Unit Agreement. In the exercise of such authority, each Working Interest Owner shall act solely in its own behalf in the capacity of an individual owner and not on behalf of the owners as an entirety.

3.2 *Specific Authorities and Duties.* The matters with respect to which the Working Interest Owners shall decided and take action shall include, but not be limited to, the following:

3.2.1 *Method of Operation.* The method of operation, including any type of pressure maintenance, secondary recovery, or other recovery program to be employed.

3.2.2 *Drilling of Wells.* The drilling of any well whether for production of Unitized Substances, for use as an injection well, or for other purposes.

3.2.3 *Well Recompletion and Change of Status.* The recompletion, abandonment, or change of status of any well, or the use of any well for injection or other purpose.

3.2.4 *Expenditures.* The making of any single expenditure in excess of Seven Thousand Five Hundred Dollars ($7,500); provided that, approval by Working Interest Owners of the drilling, reworking, deepening or plugging back of any well shall include approval of all necessary expenditures required therefore, and for completing, testing, and equipping the same, including necessary flow lines, separators, and lease tankage.

3.2.5 *Disposition of Unit Equipment.* The selling or otherwise disposing of any major items of surplus Unit Equipment, if the current list price of new equipment similar thereto is Five Thousand Dollars ($5,000) or more.

3.2.6 *Appearance Before a Court or Regulatory Agency.* The designating of a representative to appear before any court or regulatory agency in matters pertaining to Unit Operations; provided that, such designation shall not prevent any Working Interest Owner from appearing in person or from designating another representative in its own behalf.

3.2.7 *Audits.* The auditing of the accounts of Unit Operator pertaining to Unit Operations hereunder; provided that, the audits shall:

(a) not be conducted more than once each year except upon the resignation or removal of Unit Operator, and

(b) be made upon the approval of the owner or owners of a majority of Working Interest other than that of Unit Operator, at the expense of all Working Interest Owners other than Unit Operator, or

(c) be made at the expense of those Working Interest Owners requesting such audit, if owners of less than a majority of Working Interest, other than that of Unit Operator, request such an audit, and

(d) be made upon not less than thirty (30) days' written notice to Unit Operator.

3.2.8 *Inventories.* The taking of periodic inventories under the terms of Exhibit C.

3.2.9 *Technical Services.* The authorizing of charges to the joint account for services by consultants or Unit Operator's technical personnel not covered by the overhead charges provided by Exhibit C.

3.2.10 *Assignments to Committees.* The appointment of committees to study any problems in connection with Unit Operations.

3.2.11 The removal of Unit Operator and the selection of a successor.

3.2.12 The enlargement of the Unit Area.

3.2.13 The adjustment and readjustment of investments.

3.2.14 The termination of the Unit Agreement.

ARTICLE 4
MANNER OF EXERCISING SUPERVISION

4.1 *Designation of Representatives.* Each Working Interest Owner shall in writing inform Unit Operator of the names and addresses of the representative and alternate who are authorized to represent and bind such Working Interest Owner with respect to Unit Operations. The representative or alternate may be changed from time to time by written notice to Unit Operator.

4.2 *Meetings.* All meetings of Working Interest Owners shall be called by Unit Operator upon its own motion or at the request of two or more Working Interest Owners having a total Unit Participation of not less than ten percent (10%). No meeting shall be called on less than fourteen (14) days' advance written notice, with agenda for the meeting attached. Working Interest Owners who attend the meeting shall not be prevented from amending items included in the agenda or from deciding the amended item or other items presented at the meeting. The representative of Unit Operator shall be chairman of each meeting. The Unit Operator will prepare and furnish minutes of all meetings to the Working Interest Owners.

4.3 *Voting Procedure.* Working Interest Owners shall decide all matters coming before them as follows:

4.3.1 *Voting Interest.* Each Working Interest Owner shall have a voting interest equal to its Unit Participation.

4.3.2 *Voting Required-Generally.* Unless otherwise provided herein or in the Unit Agreement, all matters shall be decided by an affirm-

ative vote of sixty-five percent (65%) or more voting interest; provided that, should any Working Interest Owner have more than sixty-five percent (65%) voting interest, its vote must be supported by the vote of two or more Working Interest Owners having a combined voting interest of at least five percent (5%), and provided further, that should any one Working Interest Owner own thirty-five percent (35%) or more of the voting interest its vote will not defeat any proposal unless supported by the vote of at least two or more other Working Interest Owners having at least five percent (5%) of the voting interest.

4.3.3 *Vote at Meeting by Nonattending Working Interest Owner.* Any Working Interest Owner who is not represented at a meeting may vote by letter or telegram addressed to the representative of the Unit Operator if its vote is received prior to the vote on the item, provided that a vote of this type shall not be considered on any item amended at the meeting.

4.3.4 *Poll Votes.* Working Interest Owners may vote on and decide, by letter or telegram, any matter submitted in writing to Working Interest Owners, if no meeting is requested, as provided in Section 4.2, within seven (7) days after the proposal is sent to Working Interest Owners. Unit Operator will give prompt notice of the results of the voting to all Working Interest Owners.

ARTICLE 5
INDIVIDUAL RIGHTS OF WORKING INTEREST OWNERS

5.1 *Reservation of Rights.* Working Interest Owners severally reserve to themselves all their rights, except as otherwise provided in this agreement and the Unit Agreement.

5.2 *Specific Rights.* Each Working Interest Owner shall have, among others, the following specific rights:

5.2.1 *Access to Unit Area.* Access to the Unit Area at all reasonable times to inspect Unit Operations, all wells, and the records and data pertaining thereto.

5.2.2 *Reports.* The right to receive from Unit Operator, upon written request, copies of all reports to any governmental agency, reports of crude oil runs and stocks, inventory reports, and all other information pertaining to Unit Operations. The cost of gathering and furnishing information not ordinarily furnished by Unit Operator to all Working Interest Owners shall be charged to the Working Interest Owner who requests the information.

ARTICLE 6
UNIT OPERATOR

6.1 *Initial Unit Operator.* Sun Oil Company (Delaware) is hereby designated as Unit Operator.

6.2 *Resignation or Removal.* Unit Operator may resign at any time. Working Interest Owners may remove Unit Operator by the affirmative vote of at least seventy-five percent (75%) of the voting interest

remaining after excluding the voting interest of Unit Operator only in the event the Unit Operator fails or refused to carry out the terms of this Agreement, becomes insolvent, ceases to own an interest in the Unit Area, or if any Non-Operator submits a firm commitment in writing agreeing to operate the Unit for at least ten percent (10%) less than the total cost of operation by the present Operator. A Unit Operator that resigns or is removed shall not be released from its obligations hereunder for a period of three (3) months after the resignation or discharge unless a successor Unit Operator has taken over the Unit Operations prior to the expiration of such period.

6.3 *Selection of Successor.* Upon the resignation or removal of a Unit Operator, a successor Unit Operator shall be selected by Working Interest Owners. If the Unit Operator that is removed fails to vote or votes only to succeed itself, the successor Unit Operator may be selected by the affirmative vote of at least seventy-five percent (75%) of the voting interest remaining after excluding the voting interest of the Unit Operator that was removed.

ARTICLE 7
AUTHORITIES AND DUTIES OF UNIT OPERATOR

7.1 *Exclusive Right to Operate Unit.* Subject to the provisions of this agreement and to instructions from Working Interest Owners, Unit Operator shall have the exclusive right and be obligated to conduct Unit Operations.

7.2 *Workmanlike Conduct.* Unit Operator shall conduct Unit Operations in a good and workmanlike manner as would a prudent operator under the same or similar circumstances. Unit Operator shall freely

consult with Working Interest Owners and keep them informed of all matters which Unit Operator, in the exercise of its best judgment, considers important. Unit Operator shall not be liable to Working Interest Owners for damages, unless such damages result from its gross negligence or willful misconduct.

7.3 *Liens and Encumbrances.* Unit Operator shall endeavor to keep the lands and leases in the Unit Area free from all liens and encumbrances occasioned by Unit Operations, except the lien of Unit Operator granted hereunder.

7.4 *Employees.* The number of employees used by Unit Operator in conducting Unit Operations, their selection, hours of labor, and compensation shall be determined by Unit Operator. Such employees shall be the employees of the Unit Operator.

7.5 *Records.* Unit Operator shall keep correct books, accounts, and records of Unit Operations.

7.6 *Reports to Working Interest Owners.* Unit Operator shall furnish to Working Interest Owners monthly reports of Unit Operations.

7.7 *Reports to Governmental Authorities.* Unit Operator shall make all reports to governmental authorities that it has the duty to make as Unit Operator.

7.8 *Engineering and Geological Information.* Unit Operator shall furnish to a Working Interest Owner, upon written request, a copy of all logs and other engineering and geological data pertaining to wells drilled for Unit Operations.

7.9 *Expenditures.* Unit Operator is authorized to make single expenditures not in excess of Seven

Thousand Five Hundred Dollars ($7,500) without prior approval of Working Interest Owners. Operator shall furnish Working Interest Owners for information only copies of its cost estimates for any single project costing in excess of Five Thousand Dollars ($5,000). If an emergency occurs, Unit Operator may immediately make or incur such expenditures as in its opinion are required to deal with the emergency. Unit Operator shall report to Working Interest Owners, as promptly as possible, the nature of the emergency and the action taken.

7.10 *Wells Drilled by Unit Operator.* All wells drilled by Unit Operator shall be at the usual competitive rates prevailing in the area. Unit Operator may employ its own tools and equipment, but the charge therefor shall not exceed the prevailing competitive rate in the area, and the work shall be performed by Unit Operator under the same terms and conditions as are usual in the area in contracts of independent contractors doing work of a similar nature.

ARTICLE 8
TAXES

8.1 *Ad Valorem Taxes.* Beginning with the first calendar year after the Effective Date hereof, Unit Operator shall make and file all necessary ad valorem tax renditions and returns with the proper taxing authorities covering all real and personal property of each Working Interest Owner used or held by Unit Operator in Unit Operations. Unit Operator shall settle assessments arising therefrom. All such ad valorem taxes shall be paid by Unit Operator and charged to the Working Interest Owners in proportion to their Unit Participation.

8.2 *Other Taxes.* Each Working Interest Owner shall pay or cause to be paid all production, severance, gathering and other taxes imposed upon or in respect of the production or handling of its share of Unitized Substances.

ARTICLE 9
INSURANCE

9.1 *Insurance.* Unit Operator, with respect to Unit Operations, shall do the following:

9.1.1 Comply with the Workmen's Compensation Law of the State of Michigan.

9.1.2 Carry Employer's Liability and other insurance as required by the laws of the State of Michigan.

9.1.3 Carry other insurance as set forth in Exhibit D.

ARTICLE 10
ADJUSTMENTS OF INVESTMENTS

10.1 *Personal Property Taken Over.* Upon the Effective Date hereof, Working Interest Owners shall deliver to Unit Operator the following:

10.1.1 *Wells and Casing.* All wells completed in the Unitized Formation and wells with casing set through the Unitized Formation which are determined to be usable by Working Interest Owners, together with the casing therein.

10.1.2 *Well and Lease Equipment.* The tubing in each such well, the wellhead connections thereon, and all other lease and oper-

ating equipment that is used in the operation of such wells which Working Interest Owners determine is necessary or desirable for conducting Unit Operations.

10.1.3 *Records.* A copy of all production and well records that pertain to such wells.

10.2 *Inventory and Evaluation of Personal Property.* The Working Interest Owners shall at Unit Expense inventory and evaluate the personal property taken over. The inventory and evaluation shall include and be limited to those items of equipment normally considered controllable as indicated in the latest revision of the Material Classification Manual prepared by the Council of Petroleum Accountants Societies of North America. The Working Interest Owners may determine that other items of equipment, normally considered noncontrollable, be included in the inventory and evaluation if necessary to provide equitable adjustment of investments.

10.3 *Investment Adjustment.* Upon approval by Working Interest Owners of the inventory and evaluation, each Working Interest Owner shall be credited with the value of its interest in all personal property taken over under Sections 10.1.1 and 10.1.2 and shall be charged with an amount equal to that obtained by multiplying the total value of all personal property taken over under Sections 10.1.1 and 10.1.2 by each Working Interest Owner's Unit Participation. If the charge against any Working Interest Owner is greater than the amount credited to such Working Interest Owner, the resulting net charge shall be an item of Unit Expense chargeable against such Working Interest Owner. If the credit to any Working Interest Owner is greater than the amount charged against

such Working Interest Owner, the resulting net credit shall be paid to such Working Interest Owner by Unit Operator out of funds received by it in settlement of the net charges described above.

10.4 *Intangible Drilling Costs.* No adjustment shall be made between Working Interest Owners for intangible drilling costs.

10.5 *General Facilities.* The acquisition of warehouses, warehouse stocks, lease houses, camps, facility systems, and office buildings necessary for Unit Operations shall be by negotiation by the owners thereof and Unit Operator, subject to the approval of Working Interest Owners.

10.6 *Ownership of Personal Property and Facilities.* Each Working Interest Owner, individually, shall by virtue hereof own an undivided interest, equal to its Unit Participation, in all personal property and facilities taken over or otherwise acquired by Unit Operator pursuant to this agreement.

10.7 *Adjustment for Non-Usable Wells.* All wells delivered to the Unit Operator shall be, (a) in usable physical condition, (b) completed in some portion of the Unitized Formation, and (c) physically separated from formations not a part of the Unitized Formation as of the Effective Date. The Working Interest Owners will within three (3) months after the Effective Date, determine which wells are in non-usable physical condition. The cost of placing any such well in usable physical condition, redrilling such well, or physically separating non-unitized formations, shall be charged to the Lessee or Lessees owning the well immediately prior to the Effective Date.

ARTICLE 11
UNIT EXPENSE

11.1 *Basis of Charge to Lessees.* Unit Operator initially shall pay all Unit Expense. All charges, credits, and accounting for Unit Expense shall be in accordance with Exhibit C. Unit Expense shall be apportioned among and assessed against the Tracts in proportion to their respective Tract Participations shown on Exhibit A. Except as otherwise provided herein, the Working Interest Owners obligated or responsible for the cost and expenses of operating a Tract in the absence of unitization, in the same proportion and to the same extent, shall be chargeable with and responsible for the payment of the Unit Expense charged against such Tract.

11.2 *Budgets.* Before or as soon as practical after the effective date hereof, Unit Operator shall prepare a budget of estimated Unit Expense for the remainder of the calendar year, and, on or before the first day of each October thereafter, shall prepare such a budget for the ensuing calendar year. A budget shall set forth the estimated Unit Expense by quarterly periods. Budgets shall be estimates only, and shall be adjusted or corrected by Working Interest Owners and Unit Operator whenever an adjustment or correction is proper. A copy of each budget and adjusted budget shall promptly be furnished to each Working Interest Owner.

11.3 *Advanced Billings.* Unit Operator shall have the right to require Working Interest Owners to advance their respective shares of estimated Unit Expense by submitting to Working Interest Owners, on or before the 15th day of any month, an itemized estimate thereof for the succeeding month, with a request

for payment in advance. On or before the fifteenth (15) day of the month covered by such estimate, each Working Interest Owner shall pay to Unit Operator its share of such estimate. Adjustments between estimated and actual Unit Expense shall be made by Unit Operator at the close of each calendar month, and the accounts of Working Interest Owners shall be adjusted accordingly.

11.4 *Commingling of Funds.* No funds received by Unit Operator under this agreement need be segregated or maintained by it as a separate fund, but may be commingled with its own funds.

11.5 *Lien of Unit Operator.* Each Working Interest Owner grants to Unit Operator a lien upon its Oil and Gas Rights in each Tract, its share of Unitized Substances when produced, and its interest in all Unit Equipment, as security for payment of its share of Unit Expense, together with interest thereon at the rate of seven percent (7%) per annum or the maximum contract rate permitted by the applicable usury laws of the State of Michigan, whichever is greater. Unit Operator shall have the right to bring suit to enforce collection of such indebtedness with or without seeking foreclosure of the lien. In addition, upon default by any Working Interest Owner in the payment of its share of Unit Expense, Unit Operator shall have the right to collect from the purchaser the proceeds from the sale of such Working Interest Owner's share of Unitized Substances until the amount owed by such Working Interest Owner, plus interest as aforesaid, has been paid. Each purchaser shall be entitled to rely upon Unit Operator's written statement concerning the amount of any default.

11.6 *Unpaid Unit Expense.* If any Working Interest Owner fails or is unable to meet promptly its financial obligations in connection with the Unit, or if any Working Interest Owner elects to be carried or otherwise financed, the unpaid balance of its share of Unit Expense shall be carried and paid by all non-defaulting Working Interest Owners and Working Interest Owners not electing to be carried who are signatory to this Unit Operating Agreement in the proportion that the Unit Participation of each bears to the total such Unit Participation of all such Working Interest Owners. Such amount shall bear interest at the rate of seven percent (7%) per annum or the maximum contract rate permitted by the applicable usury laws of the State of Michigan, whichever is greater. Working Interest Owners so paying shall be reimbursed therefor, together with interest thereon, when the amount so carried and the interest thereon are collected from the Working Interest Owners primarily chargeable therewith. The amount carried shall be due and payable out of the proceeds from the defaulting Working Interest Owner's share of Unitized Substances, including overriding royalty interests, oil and gas payments, or other interests in excess of a 1/8 royalty interest to which such Working Interest Owner's interest is subject. During the time that any Working Interest Owner fails to pay its share of the Unit Expense, the Unit Operator shall be entitled to collect and receive from the purchaser the proceeds from such Working Interest Owner's share of the Unitized Substances. All credits to any such defaulting Working Interest Owner, and any Working Interest Owner being carried, on account of the sale or other disposal of Unit Equipment, or otherwise, shall also be applied against the unpaid share of Unit Expense charged against such Working Interest Owner.

11.7 *Carved-out Interest Subject to This Agreement.* In the event any Working Interest Owner shall, after executing this agreement, create an overriding royalty, production payment, net profits, or carried interest, or any other interest out of its interest then subject to this agreement, such carved-out interest shall be subject to the terms and provisions of this agreement. In the event the Working Interest Owner owning the interest out of which the carved-out interest was created fails to pay any costs or expenses chargeable to such Working Interest Owner under this agreement and the production to the credit of such Working Interest Owner is insufficient for that purpose, the owner of the carved-out interest will be liable for its pro rata portion of all costs and expenses for which the Working Interest Owner that created such carved-out interest would have been liable hereunder by virtue of such Working Interest Owner's entire original interest just as though such carved-out interest had not been created. In this event, the lien provided in Section 11.5 hereof may be enforced against such carved-out interest in the same manner as the lien was enforceable against the original interest out of which the carved-out interest was created.

ARTICLE 12
NON-UNITIZED FORMATIONS

12.1 *Right to Operate.* Any Working Interest Owner that now has or hereafter acquires the right to drill for and produce oil, gas, or other minerals, from other than the Unitized Formation, shall have the right to do so notwithstanding this agreement or the Unit Agreement. In exercising the right, however, the Working Interest Owner shall exercise reasonable pre-

caution to prevent unreasonable interference with Unit Operations. No Working Interest Owner shall produce Unitized Substances through any well drilled or operated by it. If any Working Interest Owner drills any well into or through the Unitized Formation, the Unitized Formation shall be protected in a manner satisfactory to Working Interest Owners so that the production of Unitized Substances will not adversely be affected.

12.2 *Dual Completions.* There shall be no dual completions between the unitized formation and any non-unitized formation within the Unit Area.

ARTICLE 13
TITLES

13.1 *Warranty and Indemnity.* Each person who may claim to own a working interest or royalty interest in and to any Tract or the Unitized Substances allocated thereto, shall be deemed to have warranted its title to such interest, and, upon receipt of the Unitized Substances or the proceeds thereof to the credit of such interest, shall indemnify and hold harmless the other Working Interest Owners from any loss due to failure, in whole or in part, of its title to any such interest, except failure of title arising out of Unit Operations; provided that, such in indemnity shall be limited to an amount equal to the net value that has been received from the sale or receipt of Unitized Substances attributed to the interest as to which title failed. Each failure of title will be deemed to be effective, insofar as this agreement is concerned, as of the first day of the calendar month in which such failure is finally determined, and there shall be no retroactive adjustment of Unit Expense, or retroactive allocation of Unitized Substances or the proceeds therefrom, as a result of title failure.

13.2 *Failure Because of Unit Operations.* The failure of title to any Working Interest in any Tract by reason of Unit Operations, including non-production from such Tract, shall not change the Unit Participation of the Working Interest Owner whose title failed in relation to the Unit Participations of the other Working Interest Owners at the time of the title failure.

ARTICLE 14
LIABILITY, CLAIMS, AND UNITS

14.1 *Individual Liability.* The duties, obligations and liabilities of Working Interest Owners shall be several and not joint or collective; and nothing herein contained shall ever be construed as creating a partnership of any kind, joint venture, association, or trust among Working Interest Owners.

14.2 *Settlements.* Unit Operator may settle any single damage claim or suit involving Unit Operations but not involving an expenditure in excess of Five Thousand Dollars ($5,000) provided the payment is in complete settlement of such claim or suit. If the amount required for settlement exceeds the above specified amount, Working Interest Owners shall assume and take over the further handling of the claim or suit unless such authority is expressly delegated to Unit Operator. All costs and expense of handling, settling, or otherwise discharging such claim or suit shall be an item of Unit Expense. If a claim is made against any Working Interest Owner or if any Working Interest Owner is sued on account of any matter arising from Unit Operations and over which such Working Interest Owner individually has no control because of the rights given Working Interest

Owners and Unit Operator by this agreement and the Unit Agreement, the Working Interest Owner shall immediately notify the Unit Operator, and the claim or suit shall be treated as any other claim or suit involving Unit Operations.

ARTICLE 15
INTERNAL REVENUE PROVISION

15.1 *Internal Revenue Provision.* Each Working Interest Owner hereby elects that it and the operations covered by this Agreement be excluded from the application of all of the provisions of Subchapter K, Chapter 1, Subtitle A, of the Internal Revenue Code of 1954, as amended, as permitted and authorized by Section 761 of said Code and the regulations promulgated thereunder. Unit Operator is hereby authorized and directed to execute on behalf of each of the parties hereto such evidence of this election as may be required by said regulations, to include, but not by way of limitation, all of the returns, statements, and the data required by Federal Regulations 1.761-1(a). Should there be any requirement that each party hereto further evidence this election, each party hereto agrees to execute such documents and furnish such other evidence as may be required by the Federal Internal Revenue Service or as may be necessary to evidence this election. Each party hereto further agrees not to give any notices or take any other action inconsistent with the election made hereby. If any present or future income tax laws of the state or states in which the Unit Area is located, or any future income tax of the United States, contain provisions similar to those in Subchapter K, Chapter 1, Subtitle A, of the Internal Revenue Code of 1954, as amended, under which an election similar to that provided by Section

761 of said Code is permitted, each of the parties agrees to make such election as may be permitted or required by such laws. In making this election, each of the parties states that the income derived by such party from the operations under this agreement can be adequately determined without the computation of partnership taxable income.

ARTICLE 16
NOTICES

16.1 *Notices.* All notices required hereunder shall be in writing and shall be deemed to have been properly served when sent by mail or telegram to the address of the representative of each Working Interest Owner as furnished to Unit Operator in accordance with Article 4.

ARTICLE 17
WITHDRAWAL OF WORKING INTEREST OWNER

17.1 *Withdrawal.* A Working Interest Owner may withdraw from this agreement by transferring, without warranty of title, either express or implied, to the other Working Interest Owners who do not desire to withdraw, and who elect in writing within thirty (30) days after receipt of notice from withdrawing Working Interest Owners to participate in acquiring their proportionate share of the withdrawing Working Interest Owner's share, all its Oil and Gas Rights together with its interest in all unit equipment and in all wells used in Unit Operations. Such transfer shall not relieve said Working Interest Owner from any obligation or liability incurred prior to the date of the delivery of the transfer, which delivery may be made to Unit Operator as Agent for the transferees. The interest transferred shall be owned by the transferees in proportion to

their respective Unit Participations. The transferees, in proportion to the respective interests so acquired, shall pay transferor, for its interest in Unit Equipment, the fair salvage value thereof, less the cost of total unit abandonment, as estimated and fixed by Working Interest Owners. After the date of delivery of the transfer, the withdrawing Working Interest Owner shall be relieved from all further obligations and liability hereunder and under the Unit Agreement, and the rights of such Working Interest Owner hereunder and under the Unit Agreement shall cease insofar as they existed by virtue of the interest transferred.

ARTICLE 18
ABANDONMENT OF WELLS

18.1 *Rights of Former Owners.* If Working Interest Owners decide to abandon permanently any well within the Unit Area prior to termination of the Unit Agreement, Unit Operator shall give written notice thereof to the Working Interest Owners of the Tract on which the well is located, and they shall have the option for a period of ninety (90) days after the sending of such notice to notify Unit Operator in writing of their election to take over and own the well. Within ten (10) days after the Working Interest Owners of the Tract have notified Unit Operator of their election to take over the well, they shall pay Unit Operator, for credit to the joint account, the amount estimated by Working Interest Owners to be the net salvage value of the casing and equipment in and on the well. The Working Interest Owners of the Tract, by taking over the well, agree to seal off effectively and protect the Unitized Formation, and upon abandonment to plug the well in compliance with applicable laws and regulations.

18.2 *Plugging.* If the Working Interest Owners of a Tract do not elect to take over a well located thereon which is proposed for abandonment, Unit Operator shall plug and abandon the well in compliance with applicable laws and regulations.

ARTICLE 19
EFFECTIVE DATE AND TERM

19.1 *Effective Date.* This agreement shall become effective on the date and at the time that the Unit Agreement becomes effective.

19.2 *Term.* This agreement shall continue in effect so long as the Unit Agreement remains in effect, and thereafter until (a) all unit wells have been abandoned and plugged or turned over to Working Interest Owners in accordance with Article 20; (b) all Unit Equipment and real property acquired for the joint account have been disposed of by Unit Operator in accordance with instructions of Working Interest Owners, and (c) there has been a final accounting.

ARTICLE 20
ABANDONMENT OF OPERATIONS

20.1 *Termination.* Upon termination of the Unit Agreement, the following will occur:

20.1.1 *Oil and Gas Rights.* Oil and Gas Rights in and to each separate Tract shall no longer be affected by this agreement, and thereafter the parties shall be governed by the terms and provisions of the leases, contracts, and other instruments affecting the separate Tracts.

20.1.2 *Right to Operate.* Working Interest Owners of any Tract that desire to take over

and continue to operate wells located thereon may do so by paying Unit Operator, for credit to the joint account, the net salvage value of the casing and equipment in and on the wells taken over, as estimated by Working Interest Owners, and by agreeing to plug properly each well at such time as it is abandoned.

20.1.3 *Salvaging Wells.* Unit Operator shall salvage as much of the casing and equipment in or on wells not taken over by Working Interest Owners of separate Tracts as can economically and reasonably be salvaged, as shall cause the wells to be plugged and abandoned properly.

20.1.4 *Cost of Salvaging.* Working Interest Owners shall share the cost of salvaging, liquidation or other distribution of assets and properties used in Unit Operation in proportion to their respective Unit Participations.

ARTICLE 21
EXECUTION

21.1 *Original, Counterpart, or Other Instrument.* A party may become a party to this agreement by signing the original of this instrument, a counterpart thereof, or other instrument agreeing to be bounded by the provisions hereof. The signing of any such instrument shall have the same effect as if all the parties had signed the same instrument.

ARTICLE 22
SUCCESSORS AND ASSIGNS

22.1 *Successors and Assigns.* The provisions hereof shall be covenants running with the lands, leases, and interests covered hereby, and shall be binding upon and inure to the benefit of the respective heirs, devisees, legal representatives, successors and assigns of the parties hereto.

IN WITNESS WHEREOF, the parties hereto have executed this agreement on the dates opposite their respective signatures.

UNIT OPERATOR AND WORKING INTEREST OWNER

SUN OIL COMPANY (DELAWARE)
By: /s/ V. L. Smith
Attorney in Fact

/s/ *[Illegible]*
Witness
Date: *7/10/72*

/s/ *[Illegible]*
Witness
Date: *7/10/72*

(*Jurat Omitted*)

APPENDIX I

STIPULATED EXHIBIT 15-O

ST. CLAIR CIRCUIT COURT OPINION,
WRONSKI v. *SUN OIL CO.*

(State of Michigan — Circuit Court — County of St. Clair)

(Issued December 21, 1976)

(WALTER F. WRONSKI and ELEANOR J. WRONSKI, Plaintiffs and EUGENE H. KOZIARA and ANIELA KOZIARA, Plaintiffs, v. SUN OIL COMPANY (DELAWARE), a Foreign Corporation, and WILLIAM J. MIELKE and GERALD A. PERKINS, jointly and severally, Defendants — No. 101-7; No. 103-7)

The above consolidated cases came on for trial before this Court. A jury trial was requested by Plaintiffs and denied by the Court. The trial lasted approximately three weeks with a number of witnesses being presented by each party and the Plaintiffs introducing 25 Exhibits into evidence and the Defendants introducing 56 Exhibits into evidence.

The basic theory of the Plaintiffs is that Defendant Sun Oil Company, their employees and agents, intentionally, wilfully, illegally and fraudulently overproduced approximately 182,000 barrels of oil from wells located on properties adjacent to the properties of Plaintiffs and that 1/3 of the illegally overproduced oil was drained from beneath the Plaintiffs' properties. Plaintiffs seek rescission ab initio of their respective oil and gas leases with Sun Oil Company coupled with an accounting by Sun Oil Company, and alternatively seek compensatory and exemplary or punitive damages against Defendants.

The Defendants denied any illegal overproduction and drainage of oil from the Plaintiffs' properties in their pleadings. However, at time of trial, the Defendants admit that approximately 26,000 barrels of oil could have been illegally overproduced from the oil producing properties operated by Defendants and located adjacent to the Plaintiffs' properties, but deny that such illegal overproduction resulted in any drainage of oil from beneath Plaintiffs' properties. The Defendants claim certain affirmative defenses and request that the Complaints of Plaintiffs be dismissed.

Counsel for Plaintiffs and counsel for Defendants have both submitted trial briefs covering various legal points raised by both parties.

FINDINGS OF THE COURT:

On the basis of the pleadings, and all of the testimony and Exhibits introduced into evidence, taken as a whole, the Court makes the following findings:

(1) That Plaintiffs Wronski were at all times applicable owners of approximately 120 acres of real property located in the Township of Wales and Township of Columbus, St. Clair County, described as:

> The West 1/2 of the Southeast 1/4 of Section 34, Town 6 North, Range 15 East, and also the East 1/2 of the West 1/2 of the Northeast 1/4 of Section 3, Town 5 North, Range 15 East.

(2) That at all times applicable, Plaintiffs Wronski and Defendant Sun Oil Company were parties to an oil and gas lease covering the West 1/2 of the Southeast 1/4 of Section 34, Town 6 North, Range 15 East, Wales Township, St. Clair County, Michigan, which lease was dated February 17, 1968 and recorded April 12, 1968

in Liber 936 of Deeds, Page 42, St. Clair County Register of Deeds Office, and that Defendant Sun Oil Company was the operator of one producing oil well on said property.

(3) That at all times applicable, Plaintiffs Koziara were the owners of the following described real property located in the Township of Wales, St. Clair County, Michigan, described as:

> Land situated in the Township of Wales, St. Clair County, Michigan, described as the Southwest 1/4 of the Northwest 1/4 of Section 34, and the Northeast 1/4 of the Southwest 1/4 of Section 34, Town 6 North, Range 15 East.

(4) That at all times applicable, Plaintiffs Koziara and Defendant Sun Oil Company were parties to an oil and gas lease dated March 17, 1961 and recorded March 26, 1961 in Liber 829 of Deeds, Page 311, St. Clair County Records, covering the Northeast 1/4 of the Southwest 1/4 of Section 34, Town 6 North, Range 15 East, which oil and gas lease was subsequently amended, and that Defendant Sun Oil Company was the operator of two producing oil wells on said property.

(5) That at all times applicable, Defendant Sun Oil Company was the operator of two oil and/or gas wells located on the following described 40 acre parcel:

> The Southeast 1/4 of the Southwest 1/4 of Section 34, Township 6 North, Range 15 East, Wales Township, St. Clair County, Michigan,

commonly known as the Sun-H.H. Winn et al C-1 and C-2 wells, which property and wells were located adjacent to the properties and wells of the Plaintiffs Wronski and Koziara.

(6) That at all times applicable, Defendant Sun Oil Company was the operator of eight oil and/or gas wells located on the following described property:

> The West 1/2 of the West 1/2 of the Northeast 1/4 of Section 3 and the East 1/2 of the East 1/2 of the Northwest 1/4 of Section 3 and the East 1/2 of the Southwest 1/4 of Section 3, all in Township 5 North, Range 15 East, Columbus Township, St. Clair County, Michigan,

which oil and/or gas wells were commonly known as the Sun-H.H. Winn et al Lact Facility, and which wells included the Sun-H.H. Winn No. 3 and the Sun-H.H. Winn No. 6 wells, and which wells and property were located adjacent to the property and wells of Plaintiffs Wronski and Koziara.

(7) That the oil and gas lease agreements between each of the Plaintiffs and Sun Oil Company contained a provision making all present and future rules and regulations of any governmental agency binding on the parties thereto with like effect as though incorporated in the lease agreements at length.

(8) That the Defendant Sun Oil Company was subject to an implied contractual covenant to protect the Plaintiffs Wronski and Koziara's lands from drainage and also subject to a common law duty and obligation to avoid illegal overproduction from wells located adjacent to the Plaintiffs' properties with resultant drainage.

(9) That all of the properties and wells of Plaintiffs as well as the other properties and wells operated by Defendant Sun Oil Company were part of a common pool, reservoir or field commonly known as the Columbus 3 Field, St. Clair County, Michigan.

(10) That Defendant Sun Oil Company was subject to the Proration Order of the Supervisor of Wells for the State of Michigan dated January 27, 1970 with effective date of February 1, 1970, wherein the Supervisor of Wells restricted the daily oil allowable per producing well in the Columbus 3 Field to the amount of oil that can be produced with not more than 100,000 cubic feet of gas per 24 hour day but not to exceed 75 barrels of oil per 24 hour day, and that said proration order was in effect from February 1, 1970 through June 30, 1974.

(11) That at all times applicable, Defendant Sun Oil Company was subject to the General Rules Governing Oil and Gas Operations promulgated under Act 61 of the Public Acts of 1939, as amended, for the State of Michigan of the Geological Survey Division of the Department of Natural Resources, including Rule 501, wherein the Supervisor of Wells establishes the proration of production from any oil field; Rule 504 which establishes certain limited tolerances for monthly oil production and requires all other adjustments to be by application to and written permission of the Supervisor of Wells; Rule 506 which prohibits the transfer of allowables between wells on multiple well leases; Rule 507 which prohibits wells losing production during one monthly production period from making up production during a subsequent period or from other wells; Rule 514 which makes producers responsible for regulating production so that no individual well shall produce more oil or gas than permitted by the rules and orders of the Supervisor of Wells; and Rule 517 which requires every person producing oil in any prorated oil field to report production from all wells to the Supervisor of Wells on forms provided.

(12) That Defendant Sun Oil Company systematically, intentionally and illegally overproduced the Sun-H.H. Winn et al No. 6 well in the Lact Facility during the period February 1, 1970 to June 30, 1974 and that the total amount of illegal overproduction during this period closely approximates the 93,436 barrels claimed by Plaintiff Wronski in Plaintiffs' trial Exhibit No. 9. In making this finding, the Court makes particular reference to the following testimony and evidence:

(a) Testimony and deposition introduced into evidence of Defendant Gerald R. Perkins, an employee and lease operator in the Columbus 3 Field for Defendant Sun Oil Company during all times applicable, that he (Mr. Perkins) would flow the Sun-H.H. Winn et al No. 6 well up to 24 flows per day, especially in the last week or so of a month and that the No. 6 well could have produced approximately 200 barrels per day when flowed at that rate, and the testimony of Mr. Perkins that the Sun-H.H. Winn et al No. 6 well could have produced as much as 5,000 to 6,000 barrels during a month in early 1974 when the well was consistently flowed at high rates and which production would have been substantially more than double the well's allowable. Mr. Perkins further testified that the No. 6 well could have produced at the rate of number of flows times the barrels of oil per flow as shown on the Gas-Oil Ratio Tests (Plaintiffs' Exhibit No. 14) and that the resultant overproduction of the No. 6 well could have covered the period of 1970 through June, 1974.

(b) The testimony of Mr. Jack McCarthy who operated the Sun-H.H. Winn et al No. 6 well in place of Mr. Perkins during certain periods in 1970 and 1971 that

the minimum number of flows on the No. 6 well was 12 flows per day and that during the latter part of the month the flows would be increased substantially to as high as 24 flows.

(c) The testimony of Defendant William Mielke, the Supervisor for Sun Oil Company of the Columbus 3 Field, that he (Mr. Mielke) installed a basic flow rate for the No. 6 well at 12 flows sometime during 1971 or 1972 at a time when the Gas-Oil Ratio Test showed that the No. 6 well was producing approximately 9 or 10 barrels per flow.

(d) The Pressure Control Charts introduced into evidence by the Defendants show that during February, March and April of 1974 the No. 6 well was being consistently flowed at 16 flows per day and during May and June was being consistently flowed at 14 flows per day, and that Pressure Control Charts were missing for the last few days of many months, and further, that there were some Pressure Control Charts without individual well markings with flows up to 24 flows per day, some of which could have applied to the No. 6 well during the February through June, 1974 period.

(e) The Court credits the testimony and observations on the number of flows from the No. 6 well during the period of February, 1970 through June, 1974 of Mr. Wronski.

(f) The Defendant Sun Oil Company's internal production records and the producers monthly report filed with the State of Michigan on the No. 6 well from February, 1970 through June, 1974 were falsified.

(13) That Defendant Sun Oil Company systematically, intentionally and illegally overproduced the

Sun-H.H. Winn et al No. 3 well in the Lact Facility during the period February 1, 1970 to June 30, 1974 and that the total amount of illegal overproduction during this period closely approximates the 81,494 barrels claimed by Plaintiff Wronski in Plaintiffs' trial Exhibit No. 10. In making this finding, the Court makes particular reference to the following testimony and evidence:

(a) The testimony and deposition introduced into evidence of Defendant Gerald R. Perkins that he would flow the No. 3 well, especially during the last week or so of a month up to 18 flows per day.

(b) The testimony of Defendant William Mielke that during 1971 and 1972 he established the basic flow rate for the No. 3 well at 12 flows per day, at a time when the Gas-Oil Ratio Test for the No. 3 well showed that 9.5 to 11.7 barrels were being produced per flow from the No. 3 well.

(c) The Court credits the testimony and observations of Plaintiff Wronski with respect to the No. 3 well as set forth in Plaintiffs' Exhibit No. 10 introduced into evidence.

(d) The Defendant Sun Oil Company's internal production records and the producers monthly report to the State of Michigan on the No. 3 well from February 1970 through June 1974 were falsified.

(14) That Defendant Sun Oil Company systematically, intentionally and illegally overproduced the Sun-H.H. Winn et al No. C-1 well during the period February 1, 1970 to June 30, 1974 and that the total amount of illegal overproduction during this period closely approximates the 7,500 barrels claimed by Plaintiff Wronski. In making this finding, the Court

makes particular reference to the following testimony and evidence:

(a) Defendant Sun Oil Company admitted during the trial of this case that in excess of 6,000 barrels of oil could have been illegally overproduced by the C-1 well and allocated to the C-2 well.

(b) The daily-monthly initial production records of Sun Oil Company for the C-1 and C-2 wells were falsified. Striking examples of this situation are the January, 1973, internal production records of Sun Oil Company (1525 reports) containing notations that the C-2 well was shut down for 28 days during January 1973 and only pumping one or three days. The monthly producer's report of Sun Oil Company to the State of Michigan showed the equivalent of over 22 days of production from the C-2 well during January, 1973. Another such example is the month of May, 1974 where the internal 1525 production record of Defendant Sun Oil Company, as well as the monthly producer's record of Sun Oil Company to the State of Michigan, showed the C-2 well to have produced the equivalent of 24 hours per day for the full 31 days of May, 1974. The Court credits the testimony of Mr. Wronski from his personal notes that the C-2 well was not pumping or operating for 20-1/2 days during May 1974 and was only seen to be pumping and operating for 2-1/2 days during May, 1974. The Court finds that during the period of February 1, 1970 through June 30, 1974, Defendant Sun Oil Company was illegally overproducing the C-1 well and allocating the overproduction to the C-2 well.

(15) Defendant Sun Oil Company advances a theory during the trial of the case that the illegal overproduction from the No. 6 well and No. 3 well was lim-

ited to the oil production equivalent of the amount of water from certain water producing wells, the disposal of which could not be accounted for by Sun Oil Company. The Court finds no merit to this theory. In the deposition testimony of Defendant Gerald R. Perkins, it was stated that he could not get the production out of all the other wells in the Lact Facility, some of which were water producing and others of which were not, and that some of the wells in the Lact Facility would be down with no record being made of it and overproduction from the No. 3 and No. 6 wells allocated to those wells. The Court further finds the water disposal records of Defendant Sun Oil Company to be unreliable. The water disposal records were mainly based on the period of time that a water disposal pump was operated multiplied by an assumed disposal rate. The Court credits the testimony of Mr. Wronski that he would ofttimes observe a water disposal pump pumping for an extended period of time without any reduction in the level of water in the storage tank.

(16) Defendant Sun Oil Company claimed at trial that as the number of flows on a given well was increased, the production per flow from the well would be reduced somewhat from the number of barrels per flow shown by the Gas-Oil Ratio Tests introduced into evidence. There was no specific testimony or evidence as to how much this claimed reduction of barrels per flow would be as the number of flows was increased, if, indeed, there was any reduction. There was, however, testimony by Defendant and employee Gerald R. Perkins that the production could have been the number of barrels per flow as shown on the Gas-Oil Ratio Test times the number of flows that the well was operated. The record also shows that the

amount of production from the No. 3 and No. 6 wells after unitization was extremely high in relation to the other wells in the Lact Facility, which indicates a much greater production capability of the No. 3 and No. 6 wells in relation to the other wells in the Lact Facility. The Court finds that Defendant Sun Oil Company was a wrongdoer and that Plaintiffs established a prima facie case of substantibal illegal overproduction, which transferred the burden of proof to Defendant Sun Oil Company to prove a lesser amount of illegal overproduction and the Court finds that Defendant Sun Oil Company did not meet this burden of proof. The record also reveals that there were a number of other employees of Sun Oil Company or persons working as operators for Sun Oil Company in the Columbus 3 Field during the period of time February, 1970 through June 30, 1974, none of whom were produced by Sun Oil Company for testimony, and the Court finds that their testimony would have been adverse to the Defendant Sun Oil Company.

(17) Overall, after making some allowance for the position of Sun Oil Company that there may have been some reduction in the number of barrels per flow as the number of flows was increased, and some allowance for the position of Defendant Sun Oil Company that the overproduction of the No. 3 well may be somewhat high, the Court finds that during the period of time February 1, 1970 through June 30, 1974, Defendant Sun Oil Company intentionally, wilfully and illegally overproduced the Sun-H.H. Winn et al No. 3 and No. 6 wells and the Sun-H.H. Winn et al C-1 well in the total cumulative amount of 150,000 barrels. In making this finding, the Court credits the deposition testimony of Defendant Gerald R. Perkins that both Mr. Perkins and his supervisor, Defendant and Sun Oil

Company employee William Mielke, knew that this type of overproduction was prohibited by state regulation, that both Mr. Perkins and Mr. Mielke knew that the actual production from the No. 3, No. 6 and the C-1 wells was being falsified on the 1525 internal production records of Sun Oil Company and that both Mr. Perkins and Mr. Mielke knew that upon submission of the 1525 production records to Sun Oil Company's Tulsa or Dallas office, that a Producer's monthly report form would be submitted to the State of Michigan that falsely showed only legal production from said wells, when in fact the wells were actually being illegally overproduced, and the Court finds that Defendant Sun Oil Company is responsible for these acts under the well known doctrine of "respondeat superior".

(18) The Court further finds the record void of any practices or procedures instituted by Defendant Sun Oil Company to avoid such illegal overproduction and to protect the interests of adjacent property owners such as the Wronskis and the Koziaras from drainage. The Court further finds that the testimony and evidence as a whole show that the practices, procedures and operations conducted by Defendant Sun Oil Company encouraged and facilitated the type of illegal overproduction found in this case.

(19) The Court credits the testimony of Plaintiffs' expert William Brittain, that 1/3 of the illegal overproduction by Defendant Sun Oil Company was drained from beneath the lands of the Plaintiffs Wronski and Koziara and finds that 50,000 barrels of oil were illegally drained from beneath the Wronski and Koziara lands during the period February 1, 1970 through

June 30, 1974 and that the allocation of the drainage between said properties was in accordance with their respective participation percentages as set forth in Plaintiffs' trial Exhibit No. 7.

(20) The Court finds no merit to the position of Defendant Sun Oil Company's experts at trial that there would have been no drainage even from the systematic illegal overproduction of over 180,000 barrels of oil over the period of nearly 4-1/2 years. The Court further invokes the equitable principle that all things are to be presumed against the wrongdoer, Defendant Sun Oil Company, and that it would be inappropriate to consider the effect, if any, that legal production may have had on the illegal overproduction of Sun Oil Company. In making the above finding, the Court has also considered the fact that if Sun Oil Company had not illegally overproduced the 150,000 barrels of oil found in this case, the oil would still be in a reservoir and in the event the unitization of the Columbus 3 Field is upheld, that the Plaintiffs Wronskis and Koziaras would be participating in the production of this oil at least to the extent of their total participation percentages as set forth in Plaintiffs' Exhibit No. 7, which constitute 22.99422% of the field. The Court has also considered the fact that the participation percentages set forth in Plaintiffs' Exhibit No. 7 were based on a formula that included a 60% factor for production for the fourth quarter of 1971, during which time this Court has found Sun Oil Company to have been illegally overproducing the No. 3, No. 6 and the C-1 wells. The testimony of Mr. John Lorenz, an employee of the State of Michigan Department of Natural Resources in charge of proration, was that he would not consider illegal overproduction in determining participation percentages, although he stated

that he was not speaking for the whole Department. It therefore occurs to this Court that the tract participation percentages of Plaintiffs Wronski and Koziara as set forth in Plaintiffs' Exhibit No. 7 are conservative to the degree that they reflect illegal overproduction for other participants.

(21) The Court has considered the relief of rescission ab initio requested by the Plaintiffs in this case and decided not to grant such relief.

(22) The Court has considered the commingling theory of Plaintiffs in this case and determined not to implement same.

(23) The Court finds that the fact situation in the consolidated cases before the Court wherein Sun Oil Company intentionally falsified its production records and intentionally illegally overproduced the wells in question is closely analogous to the fact situation in the 1969 Oklahoma case of *Hall Jones Oil Corp* v *Claro,* 259 P2d 858, cited in Plaintiffs' trial brief and that Defendant Sun Oil Company's conduct herein amounts to harsh dealings and sharp practice properly deserving to be labeled fraudulent drainage.

(24) The Court further finds that Defendant Sun Oil Company has intentionally breached their implied covenant under the respective Wronski and Koziara oil and gas leases to protect the Wronski and Koziara lands from drainage. The Court further finds that the Defendant Sun Oil Company has intentionally breached its contractual commitments in the respective oil and gas leases with the Wronskis and the Koziaras to comply with all of the rules and regulations promulgated by governmental agencies including the orders and rules of the Supervisor of Wells of the Department of Natural Resources for the

State of Michigan. The Court further finds these breaches to be tortious breaches of these contractual obligations. The Court further finds that Defendant Sun Oil Company has violated the common law rights of Plaintiffs Wronski and Koziara by illegally, unlawfully and secretly draining valuable oil from beneath their properties.

(25) The Court finds compensatory and exemplary damages to be awarded Plaintiffs and assessed against Defendant Sun Oil Company to be the appropriate relief in these consolidated cases.

(26) In granting compensatory damages, the Court finds that the value of the oil per barrel that was illegally drained from beneath the Plaintiffs Wronski and Koziara properties to be $12.50 per barrel. The Plaintiffs argue that the price per barrel should be $13.35 per barrel and the trial testimony is in agreement that $13.35 is the highest price per barrel that the Plaintiffs Wronski and Koziara received as of the time of trial. Defendant Sun Oil Company argues that the price per barrel should be $3.65 per barrel, which is the average price from February, 1970 through June, 1974 for oil taken from the field. Defendant Sun Oil Company's argument is based on a claim the Defendant Sun Oil Company had a contractual right to withdraw tihis oil based on the oil and gas leases then in effect between Sun Oil Company and the Plaintiffs Wronski and Koziara. The Court finds no merit to this position. Defendant Sun Oil Company had no contractual right to withdraw more than 75 barrels per day from each well on the Wronski and Koziara properties that they had covered by lease. Secret, illegal drainage was not permitted by contract. On the contrary, such drainage constitutes a breach of contract

with respect to said leases, including breach of the implied covenants to prevent drainage and breach of the specific contractual agreement to comply with the rules and regulations of the State of Michigan. Again, implementing the equitable principle of presuming all things against the wrongdoer Defendant Sun Oil Company, the Court finds $12.50 per barrel to be a reasonable average price for determination of compensatory damages. In making this determination, the Court has further considered that had Sun Oil Company not illegally overproduced these properties, the oil would still be in the reservoir and presumably insure to the benefit of Plaintiffs at the higher present day prices.

(27) The Court finds that the 50,000 barrels of oil illegally drained from beneath the Wronski and Koziara tracts are to be valued at the rate of $12.50 per barrel, are to be allocated in accordance with their relative allocation factors based on the participation percentages set forth in Plaintiff's Exhibit No. 7 and reduced by the percentage royalty ownership of the respective Plaintiffs in each tract. The Court finds Koziara Tract No. 1 to have an allocation factor of .405% and a royalty ownership of 100%; Koziara Tract No. 2 to have an allocation factor of 13.212% and a royalty ownership of 20.83%; Koziara Tract No. 6 to have an allocation factor of 59.218% and a royalty ownership of 18.75%. The Court finds compensatory damages to be awarded the Plaintiffs Koziara against Defendant Sun Oil Company in the total amount of Eighty-Nine Thousand One Hundred Twenty-Seven and 00/100 ($89,127.00) Dollars.

The Court finds the Wronski Tract No. 7 to have an allocation factor of 26.421% and a royalty percentage of 12.5%; the Wronski Tract No. 13 to have an alloca-

tion factor of .743% and a royalty interest of 100%. The Court finds compensatory damages to be awarded the Plaintiffs Wronski in the amount of Twenty-Five Thousand Two Hundred Eighty-Four and 00/100 ($25,284.00) Dollars and assessed against the Defendant Sun Oil Company.

(28) The Court finds exemplary damages to be assessed against Defendant Sun Oil Company to be appropriate additional relief. In determining exemplary damages, the Court has considered the following:

(a) That Defendant Sun Oil Company's conduct is properly labeled fraudulent drainage.

(b) That Defendant Sun Oil Company's conduct was intentional and wilful and in reckless disregard of the Plaintiffs' rights.

(c) That the Defendant Sun Oil Company's conduct constituted a tortious breach of the respective contract rights of Plaintiffs and an intentional wilful violation of Plaintiffs' common law property rights.

(d) That the practices and procedures of Defendant Sun Oil Company facilitate and encourage the illegal overproduction and drainage of oil and the Court is concerned that there may be many other parties similarly situated to the Plaintiffs Wronski and Koziara who have been or may be illegally drained and damaged without their knowledge.

(e) That the award of compensatory damages only would constitute a payment by Defendant Sun Oil Company for illegally extracted oil basically in the same manner as if Defendant Sun Oil Company had legally extracted the oil.

(f) The Court finds even with the payment of compensatory damages as set forth in this case, that the Defendant Sun Oil Company would make substantial profit from their illegal activities.

(g) The Court finds the primary purpose of exemplary damages in Michigan to be an assessment of damages against a defendant that will discourage the defendant from continuing with intentional, wilful and illegal acts and to encourage a defendant to adopt practices and procedures that will prevent damages and losses to plaintiffs as well as to parties similarly situated to plaintiffs.

(h) In considering the amount of exemplary damages to be assessed against Defendant Sun Oil Company in this case, the Court takes judicial notice that the legislature of the State of Michigan has enacted a number of different treble damage statutes. These treble damage statutes are by their nature exemplary and punitive in effect. MSA 27A.2919; MCLA 600.2919; sets forth a treble damage statute that is closely analogous to the facts in the case at bar. Section 2919 states in part:

> "(1) Any person who: . . .
> (b) Digs up or carries away stone, ore, gravel, clay, sand, turf or mould or any root, fruit or plant from another's lands . . . without permission of the owner of the lands . . . is liable to the owner of the land . . . for three times the amount of actual damages . . ."

This treble damage statute has not been applied where a defendant has proven that his trespass was casual and involuntary and not wilful. The treble damages have been applied

> where the trespass was wilful or in reckless disregard of the rights of the plaintiff. In the case at bar, the actions of the Defendant Sun Oil Company in intentionally, wilfully and illegally overproducing adjacent wells and draining oil from beneath Plaintiffs' properties is in the nature of a trespass. Defendant Sun Oil Company had no legal or contractual right to drain Plaintiffs' properties. The drainage was a wilful, tortious breach of Plaintiffs' contract rights and violation of Sun Oil Company's common law obligations to Plaintiffs and in violation of Plaintiffs' property rights. The "stone, ore, gravel, clay, sand" referred to in Section 2919 is comparable in kind to the oil that was drained by Defendant Sun Oil Company. The Court finds reference to MSA 27A.2919 (MCLA 600.2919) and the other Michigan treble damages statutes as a proper guideline to consider in affixing exemplary damages in this case.

The Court determines on the basis of all of the testimony and evidence in this case and after considering the matters stated above, that it would be reasonable and proper to assess exemplary damages against Defendant Sun Oil Company in the amount of Fifty (50%) per cent of the compensatory damages previously awarded to the Plaintiffs. The Court finds exemplary damages to be assessed against Defendant Sun Oil Company in the amount of Forty-Four Thousand Five Hundred Sixty-Three and 50/100 ($44,563.50) Dollars and awarded to Plaintiffs Eugene H. Koziara and Aniela Koziara. The Court finds exemplary damages to be assessed against Defendant Sun Oil Company in the amount of Twelve Thousand Six Hundred Forty-Two ($12,642.00) Dollars and awarded to Plaintiffs Walter F. Wronski and Eleanor J. Wronski.

(29) The Court finds the Defendant Gerald R. Perkins to have been an active participant, as an employee of Sun Oil Company, in the total activities of Sun Oil Company complained of and the Court assesses nominal damages against Defendant Gerald R. Perkins in the amount of One and 00/100 ($1.00) Dollar in favor of the Plaintiffs Wronski and Koziara.

(30) The Court finds the Defendant William J. Mielke to have been an active participant as an employee of Sun Oil Company in the total activities of Sun Oil Company complained of, and the Court assesses nominal damages against Defendant William J. Mielke in the amount of One and 00/100 ($1.00) Dollar in favor of the Plaintiffs Wronski and Koziara.

(31) The Court dismisses as without merit the affirmative defense of Defendants that Plaintiffs have failed to state a cause of action. It is abundantly clear from the pleadings, evidence and the findings of this Court that Plaintiffs have stated a meritorious cause of action against Defendants for illegal drainage, tortious breach of contract and violation of Plaintiffs' property rights.

(32) The Court dismisses as without merit the affirmative defense of Defendants that the primary jurisdiction is with the Director of the Michigan Department of Natural Resources who acts as the Supervisor of Wells pursuant to Act 61 of 1939, as amended. The Court finds primary jurisdiction for illegal drainage occurring in St. Clair County, for tortious breach of contract and violation of Plaintiffs' property rights by Defendants in St. Clair County to be vested in the St. Clair County Circuit Court.

(33) The Court dismisses as without merit Defendant's affirmative defense that Plaintiffs have failed to

exhaust their administrative remedies. The Court finds that the claims of Plaintiffs of illegal drainage, tortious breach of contract and violation to Plaintiffs' property rights as well as the remedies sought by Plaintiffs to be legal and/or equitable in nature; that such claims and remedies are not cognizable by administrative agencies, and that Plaintiffs had no duty to exhaust administrative remedies, if indeed any such remedies were available.

(34) The Court dismisses as without merit the affirmative defense of Defendants that this Court lacks jurisdiction of the subject matter. The activities of Defendants complained of occurred in St. Clair County. The tortious breach of contract and violation of Plaintiffs' property rights occurred in St. Clair County. The claims of Plaintiffs and the remedies sought by Plaintiffs are within the jurisdiction of the Circit Court for St. Clair County.

(35) The Defendants' affirmative defense that Plaintiffs have not stated facts showing they are entitled to equitable relief is a moot question, this Court having denied Plaintiffs' request for the equitable relief of rescission ab initio and this Court having granted the alternate relief at law of compensatory and exemplary damages.

(36) Defendants' affirmative defense that Plaintiffs are not entitled to equitable relief due to laches is also a moot question for the reasons previously stated. Nevertheless, the Court finds that the Plaintiffs are not guilty of laches in this case. During the period of February 1, 1970 through June 30, 1974 the Defendant Sun Oil Company controlled all of the production, record keeping and reports on the wells in question and concealed their illegal overproduction

and drainage from Plaintiffs. The record is clear that the Plaintiffs did not confirm the illegal overproduction and drainage until the March 5, 1975 deposition of Defendant Gerald R. Perkins in a related case. Plaintiffs timely filed their Complaints in this action on or about April 17, 1975. There was no delay on the part of Plaintiffs and no change in position on the part of Defendants that could give rise to the equitable defense of laches.

(37) The Defendants' affirmative defense that Plaintiff are not entitled to equitable relief of recission in that Defendant Sun Oil Company cannot be restored to the status quo is a moot question for the reasons previously stated.

(38) The Court dismisses as without merit the affirmat defense of Defendants that a stipulation consisting of a settlement of all claims between the Defendant Sun Oil Company and the Plaintiffs Koziara, only, in an unrelated case is a bar all claims arising on or before November 4, 1971 with respect to Plaintiffs Koziara only. The record is clear that the Plaintiffs Koziara would not have entered into the stipulation and release of November 4, 1971 had they had notice or knowledge of the illegal drainage of oil being perpetrated by Sun Oil Company during the period February 1, 1970 through November 4, 1971 and thereafter. The record is clear that Defendant Sun Oil Company concealed their illegal drainage of oil from the Koziara properties' from the Koziaras from February 1, 1970 through November 4, 1971 and thereafter. This Court has found that the activity and practices of Defendant Sun Oil Company constituted fraudulent drainage and it would be unconscionable for this Court to give any effect to the November 4, 1971 stipulation and release in relation to this case.

(39) The Court dismisses as without merit the affirmative defense of Defendants that on or about November 19, 1975, Plaintiffs Walter F. Wronski and Eugene H. Koziara filed their Complaints with the Michigan Supervisor of Wells pursuant to 1939 PA 61 with respect to alleged overproduction. The Court finds that this was an attempt by Plaintiffs to have the Supervisor of Wells and/or the Michigan Attorney General's Office invoke the quasi-criminal provisions of Act 61 of Public Acts of 1939 against Defendant Sun Oil Company and are not relevant to this case.

(40) The Court dismisses as without merit the additional affirmative defense advanced by Defendants at time of trial that the Plaintiffs Wronski and Koziara waived their rights by accepting royalty checks from Defendant Sun Oil Company after the June 30, 1974 unitization or after the commencement of this drainage action. The record is clear that all of the royalty checks received by the Plaintiffs Wronski and Koziara were endorsed "without prejudice" after June 30, 1974. No evidence was introduced by Defendant Sun Oil Company to rebut this. Plaintiffs introduced a copy of a September 13, 1974 letter from counsel for Plaintiffs to counsel for Defendant Sun Oil Company confirming that no position of waiver, estoppel or other technical position would be taken by Defendant Sun Oil Company with respect to the acceptance and cashing of royalty checks. The record in this case reveals no rescission of that understanding. The Court also finds that, regardless of the relief entered by this Court in this case, the Plaintiffs would always have the right to such royalty interest payments. For this Court to give any effect to an affirmative defense of waiver by reason of Plaintiffs cashing of royalty checks under these circumstances would be unconscionable.

Judgment may be entered in these consolidated cases in accordance with this Opinion. Costs are to be awarded Plaintiffs and assessed against Defendant Sun Oil Company.

/s/ Halford I. Streeter,
Circuit Judge

Dated: December 21, 1976.

APPENDIX J

STIPULATED EXHIBIT 19-S

EXHIBIT "A" to UNIT AGREEMENT

(Columbus Three Unit — St. Clair County, Michigan)

TRACTS AND TRACT PARTICIPATION PERCENTAGES

Tract No.	*Tract Name*	*Description*	*Tract Participation*
1	E. Koziara	W 1/2 SW 1/4 NW 1/4 of Section 34-T6N-R15E	.09324
2	E. Koziara	E 1/2 SW 1/4 NW 1/4 of Section 34-T6N-R15E	3.03803
3	M. Shanahan	W 1/2 SE 1/4 NW 1/4 of Section 34-T6N-R15E	6.56866
4	Shanahan & Nolan	E 1/2 SE 1/4 NW 1/4 of Section 34-T6N-R15E	.32011
5	W. Curzydło	E 1/2 SW 1/4 SW 1/4 & NW 1/4 SW 1/4 of Section 34-T6N-R15E	13.34844
6	F. Koziara	NE 1/4 SW 1/4 of Section 34-T6N-R15E	13.61672
7	W.F. Wronski	W 1/2 SE 1/4 of Section 34-T6N-R15E	6.07530
8	T. Romanow	W 1/2 SW 1/4 SW 1/4 of Section 34-T6N-R15E	.02020
9	H.H. Winn "C"	SE 1/4 SW 1/4 of Section 34-T6N-R15E	10.54787
10	T. Romanow	E 1/2 W 1/2 NW 1/4 of Section 3-T5N-R15E	.00622

Tract No.	*Tract Name*	*Description*	*Tract Participation*
11	F. Holowitz, et al	W1/2 E1/2 NW1/4 of Section 3-T5N-R15E	.70834
12	H.H. Winn, et al	E1/2 SW1/4 & E1/2 E1/2 NW1/4 & W1/2 W1/2 NE1/4 of Section 3-T5N-R15E	31.93710
13	W.F. Wronski	E1/2 W1/2 NE1/4 of Section 3-T5N-R15E	.17093
14	F.J. Winn	W1/2 SW1/4 of Section 3-5N-15E	.00932
15	H.H. Winn "B"	W1/2 SE1/4 of Section 3-T5N-R15E	10.35168
16	F.J. Winn "B"	N1/4 NW1/4 of Section 10-5N-15E	.47551
17	Lippstreuer	NE1/4 NW1/4 of Section 10-T5N-R15E	2.60356
18	E.J. Fraley	W1/2 NW1/4 NE1/2 of Section 10-5N-15E	.10877
			100.00000